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**Balancism: A new legal and economic model for just distribution wealth and systemic financial stability**

Imani Markid, Maghsoud

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# **BALANCISM:**

**A NEW LEGAL AND ECONOMIC MODEL FOR JUST DISTRIBUTION OF  
WEALTH AND SYSTEMIC FINANCIAL STABILITY**

Thesis Submitted for the Degree of PhD in Law by

**Maghsoud Imani Markid**

London, May 2013

The Dickson Poon School of Law  
King's College London

## **Abstract**

The modern economic and financial systems have not so far secured a just and fair system of distribution of wealth and have frequently been exposed as containing systemic instabilities. In response, some think that there is no choice but to follow the laws and claims of Capitalism. Others have argued that it is time to revive and implement Socialism. Still others have voiced their support that the Islamic model would be the best solution. This thesis, which is an interdisciplinary and a comparative work, aims to suggest a new solution. The alternative system introduced in this research project is a comprehensive paradigm and three-tier model. The first tier covers the ultimate objective (social justice), the new foundational theory (rights-and-duties balance/benefits-and-burdens balance “Balancism”) as well as fundamental principles and policies of the model (e.g., distribution of the proceeds of natural wealth resources according to the reasonable and legitimate needs of human beings, distribution of subordinate wealth on the basis of contribution, application of an unlimited proportionate liability standard instead of the current limited liability norm, implementation of sharing-in-income arrangement instead of modern labour employment structure, securing basic essential needs of humanity, preventing concentration of wealth, and minimizing risk rather than taking advantage of it). In the second tier, major tools, products, and facilities are suggested for distribution of the proceeds of primary wealth resources and also for for-profit, profit-free, philanthropic, microfinance, intermediary, and risk hedging activities. The third tier deals with the superstructure and political regime of the alternative system. It consists of a “House of Wealth” and a “House of Market Control”. The Houses have to follow and apply the rules of balance, the first in the system of distribution of primary wealth and the second in the circulation of subordinate wealth, in order to ensure that justice prevails.

## **Dedication**

*To my Wife Zeinab Sobhanallahi & my Daughter Mobina*

## Acknowledgements

It has been a long and hard, but also enjoyable journey from which I have learned a lot. I frequently had to travel from the UK to the US, where I also did my LLM programme at UC Berkeley, but never had a chance to go back to my motherland Iran to visit my family, country, and friends. This was indeed the toughest part!

Many people have helped me intellectually, financially and emotionally to make the thesis possible and I am indebted to all of them. Space only permits to mention the name of some.

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## **Chapter One:**

# **Introduction, Background, Methodology and the First Tier of the Model**

## 1.1 General Introduction

The modern economic and financial systems have proved to be flawed and have been the subject of much criticism. They have not so far secured a just and fair system of distribution of wealth and have frequently been exposed as containing systemic instabilities. This thesis recognises these problems and aims to find a model with its own new foundational theory in which the competing interests of different participants are better balanced and that is more stable, just and fair in terms of the distribution of wealth, with the eventual goal of showing that all countries would be happier if they follow the new system. The research is an interdisciplinary and a comparative work and it also benefits from Islamic law, economics and finance as well as Western (especially US and UK) best practices and law.

The alternative economic, business and financial system suggested by the thesis is a three-tier model. The first tier covers the ultimate objective, the new foundational theory, and fundamental principles and policies of the model. In the second tier, all major and necessary tools, products and services are provided. The third tier covers the superstructure and controlling authorities of the system.

Regarding the first tier, the ultimate objective of the alternative model is to achieve “social justice”, following the achievement of a better balanced economic and financial system.<sup>1</sup> In this context, this research project considers justice to be the same as a balance of rights and duties. The new foundational theory introduced by the research project is called “Rights-and-Duties Balance” generally and “Benefits-and-Burdens Balance” in a specific economic context. The fundamental principles and policies- derived from the ultimate objective and foundational theory of the thesis- on

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<sup>1</sup> To achieve social justice, justice should be met in every aspect of social life such as education, culture, economy, politics and business opportunities. The focus here is made on economic and financial aspects of social justice.

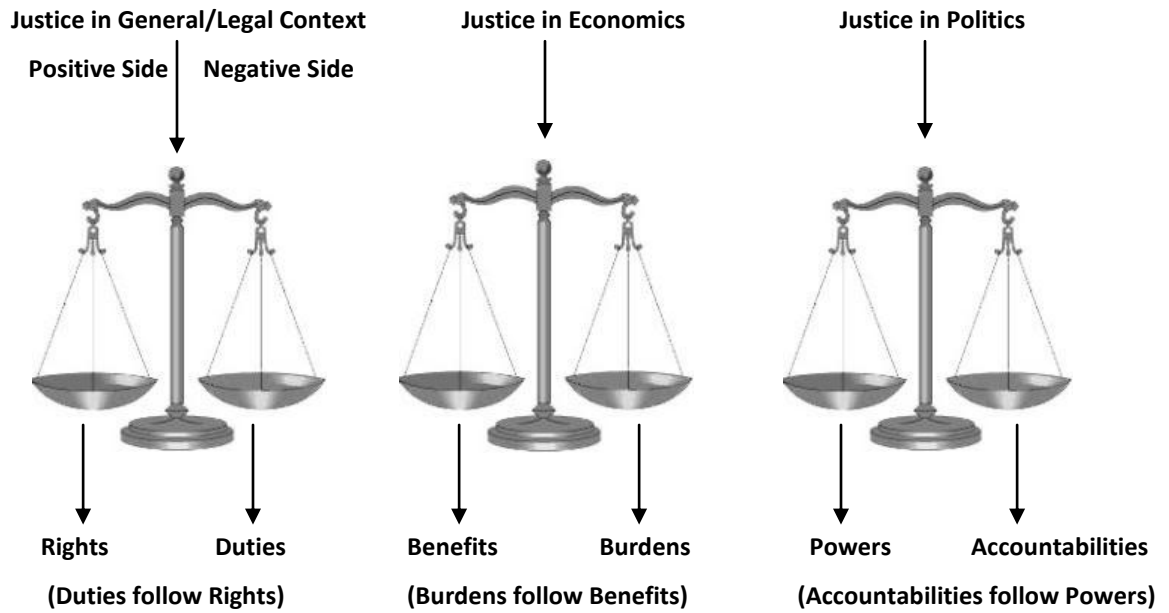
the basis of which the second tier of the model (tools and products) is built up are categorised into two different types. The first type of principles and policies governs distribution of the proceeds of primary wealth. The second type of principles and policies deals with the circulation of subordinate wealth.

In the second tier of the model, major tools, products, and facilities are suggested for “distribution of the proceeds of primary wealth resources” and also “for profit”, “profit-free”, “philanthropic”, “microfinance”, “intermediary”, and “risk hedging” activities mainly with respect to the circulation of subordinate wealth. This is the backbone of how the second tier is built up. The starting point is to determine how the proceeds of natural wealth resources can be distributed. The suggestion is that it should be distributed according to reasonable needs of humanity. As far as the circulation of subordinate wealth concerned, the issue is to identify and recognise the economic, business and financial needs of humanity and then seek proper solutions to fulfil these needs. In fulfilling the needs, the first question is how one can acquire or dispose of an asset. The aim of the former is to respond to the demands of an asset applicant and the latter of an asset holder. The needs of an asset applicant or asset holder are either: for profit-making, for no profit (profit-free), philanthropic, or for microbusiness purposes. In other words, an asset may be used in one of these ways: using the asset for generating profit; allowing somebody else to use or enjoy the asset free of charge; surrendering the ownership of the asset for some good purposes; or the combination of these ways- i.e., for microbusiness purposes. All these categorised purposes require their own specifically-tailored instruments, forms, and products. In addition, sometimes a person needs somebody else’s services to carry out his legal and administrative actions or economic, business and financial affairs. For this purpose, specifically-tailored intermediary tools and services are provided. Moreover, the necessary needs of people, especially investors, have always been to secure and

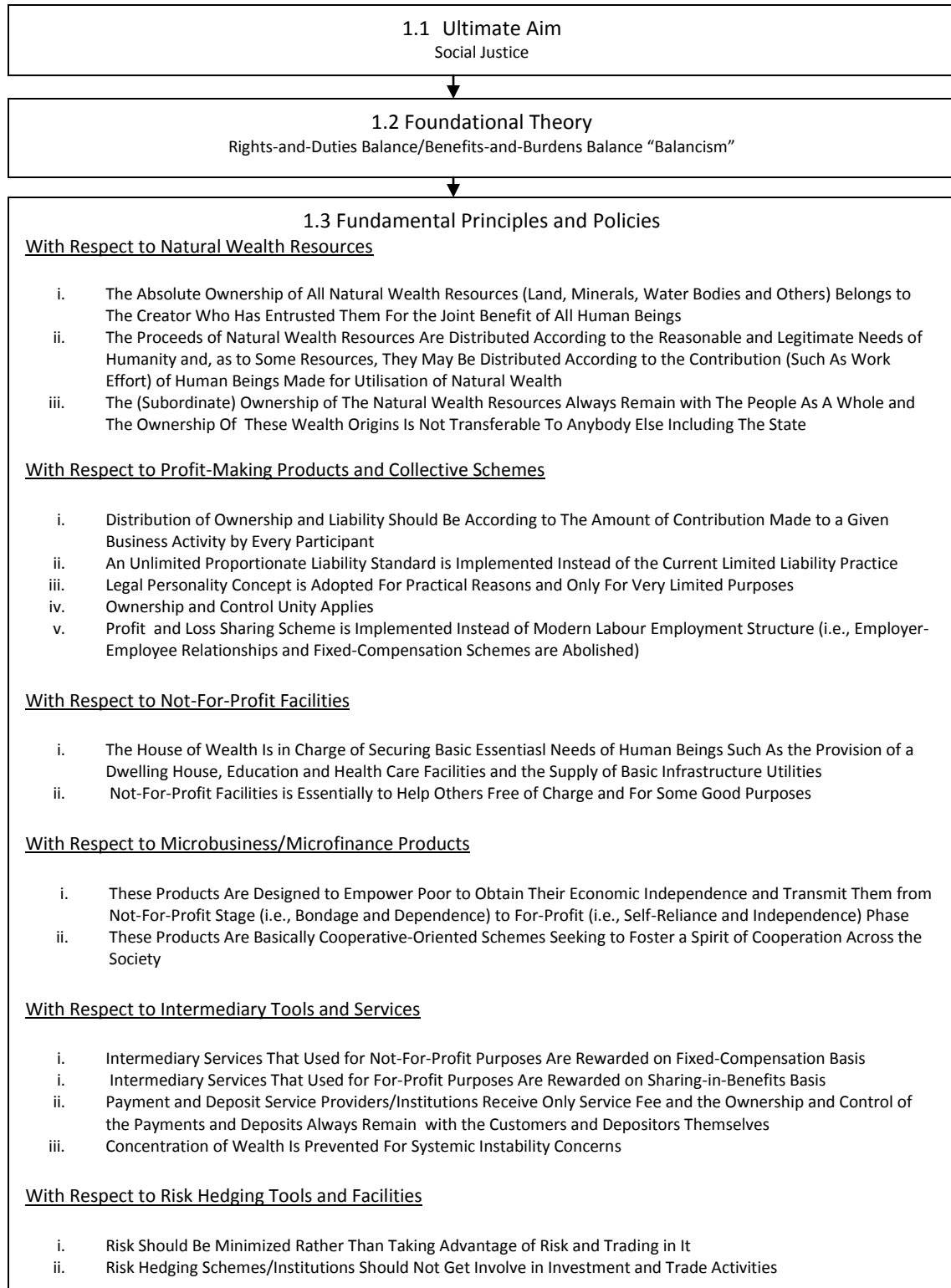
protect their properties against risk. For this purpose, specifically-tailored risk protection tools and facilities are offered.

Finally, the third tier deals with the superstructure and political regime of the alternative system. It consists of a “House of Wealth” and a “House of Market Control” including authorities that may be set up under each of these Houses where it is necessary for proper management and control of the system. The “House of Wealth” is run by a Board of Trustees, who are entrusted with administrative management power of the primary wealth and elected directly by members of the public or indirectly by representatives of the public e.g., through a Parliemant. The main function of this House is to manage natural wealth resources and distribute the proceeds of these resources among members of the public. The “House of Market Control” is also set up to control the proper circulation of subordinate wealth in the system. The House of Market Control is an independent, exclusive, unified and central regulatory, supervisory authority responsible for controlling the market and the proper circulation of subordinate wealth. Both the House of Wealth and the House of Market Control have to follow and apply the rules of balance, the first in the system of distribution of primary wealth and the second in the circulation of subordinate wealth, in order to ensure that justice prevails.

**Figure 1: Justice in Different Contexts**



**Figure 2: The First Tier of the Model**





**Figure 3: The Second Tier of the Model**

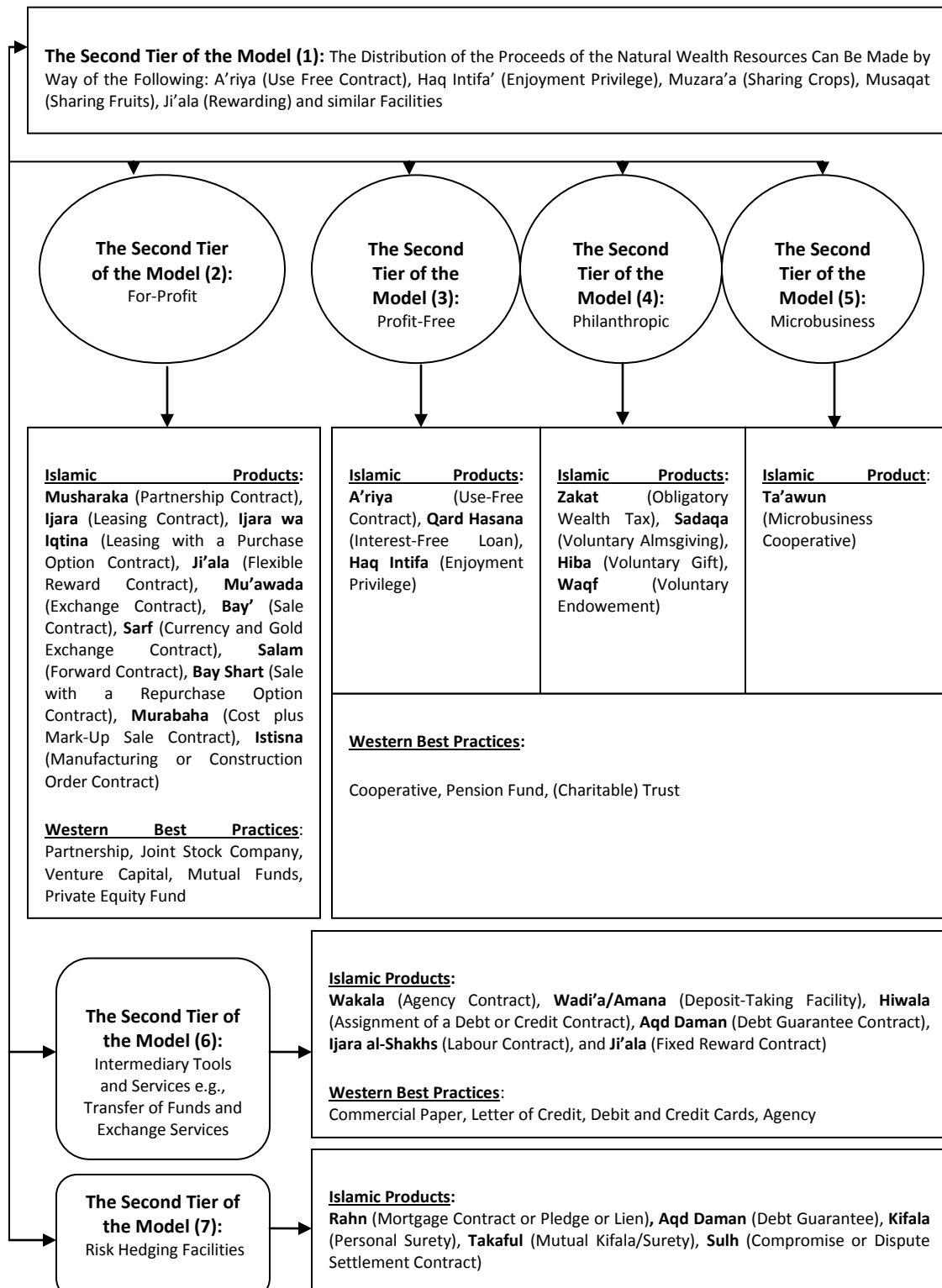
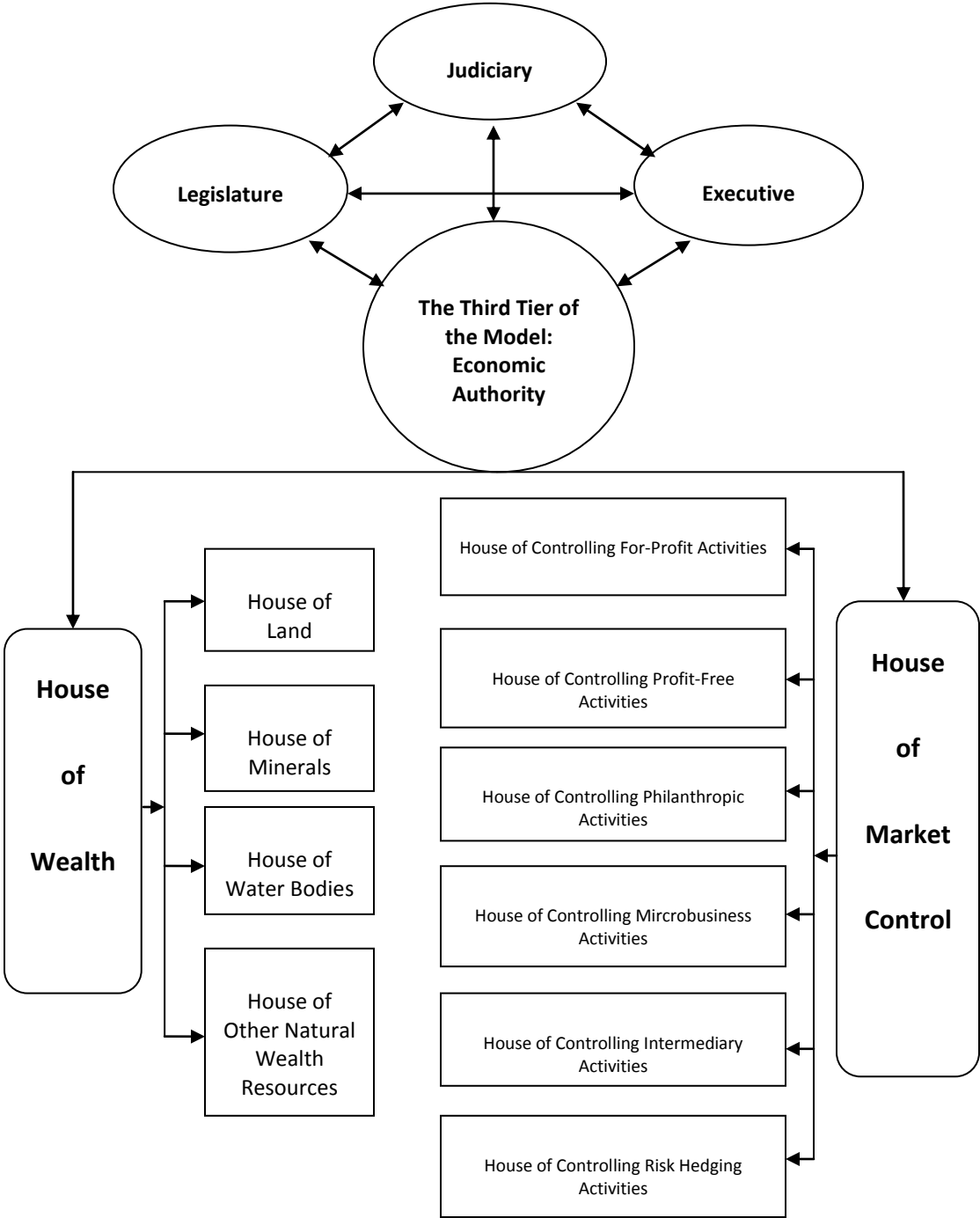


Figure 4: The Third Tier of the Model



## **1.2 Problems, Questions, Necessity, Importance, and Aim of the Research Project**

### **1.2.1 Problems**

Historically, whenever financial hardship has gone beyond the tolerable level for those of limited means, movements have sprung up against economic inequality. The most recent movement in this regard is the “Occupy Movement” using the slogan “We are the 99%”, protesting against the ever-increasing gap between rich and poor.<sup>2</sup> Today, there continue to be many people who live in poverty and are unable to provide for their basic needs, such as: food, housing, health and education while most of the wealth is controlled by a small percentage of people. In particular this includes multinational corporations and a few so-called ‘mega’ banks worldwide and they

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<sup>2</sup> The first Occupy protest that received wide media coverage was Occupy Wall Street in New York City, which started in September 17, 2011 and was followed in major cities around the world. Some organizers and supporters called the day as the United States Day of Rage. The primary goal of the Movement is to change the dominant economic structure into something fairer and more just. See Colin Moynihan ‘Wall Street Protest Begins, With Demonstrators Blocked’ (City Room, Blog of The New York Times, September 17, 2011) Retrieved March 04, 2013. See also Paul Harris ‘Occupy Wall Street: The Protesters Speak – The Anti-Capitalist Protesters Who Have Set up Camp in Lower Manhattan Are Becoming a Fixture of the Area’ (London: News Blog, Blog of The Guardian, September 21, 2011) Retrieved March 04, 2013. The Financial Times published an editorial in October 17, 2011 supporting the Movement. It ends by saying that this “cry for change” must be “heeded”. The New York Times also published an editorial in October 8, 2011 supporting the Movement. It ends by saying that “it is not the job of the protesters to draft legislation. That’s the job of the nation’s leaders, and ... the public airing of grievances is a legitimate and important end in itself. It is also the first line of defense against a return to the Wall Street ways that plunged the nation into an economic crisis from which it has yet to emerge”.

decide how the world economy is to be run.<sup>3</sup> They have made many countries dependent on banking loans and other credit facilities. This bondage has significantly undermined the dignity and independence of many countries and affected their

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<sup>3</sup> The findings of a University of Zurich (Swiss Federal Institute of Technology) research published on 19 September 2011 uncover what anti-capitalist activists and movements have been claiming for years- that a very few group of deeply interconnected entities- especially banks- tied together in an extremely entangled web of control actually run the global economy. The research is the first to study all 43,060 transnational corporations and the web of ownership between them- and formulated a “map” of 1,318 companies that sit at the heart of global business and within this group a “super-entity” of 147 companies that control 40% of the wealth within the multinational business network. As per the researchers, each of the 147 companies is owned by other companies within the “super-entity” essentially creating a self-contained network of wealth. According to the researchers, this concentration of wealth in the hands of a small group of corporations, when those entities become too interconnected, it can cause chain reactions that can shake the economy systematically. In other words, the close connections mean that the network could be alarmingly susceptible to shocks and collapse. As per co-author of the study James Glattfelder “If one [entity] suffers distress, this propagates [itself]”. This evidence fits with the late-2000s financial crisis experience that began as a problem of excessive liabilities at a very few of financial entities. Since these entities had financial connections to the rest of the financial industry, their bankruptcy took down the entire financial system. In their conclusion, the researchers claim that their study is evidence that the world may need global anti-trust policy and rules- that designed to keep entities from becoming too large and too interconnected in their sector, or from joining de facto arrangements to cooperate with their competitors. According to the study, the top five corporations are: Barclays (a British bank), Capital Group Companies (a US-based investment management organisation), Fidelity Investments (a US-based multinational financial services corporation), AXA Insurance (a French global insurance group) and State Street Corporation (a US-based financial services holding company). See Stefania Vitali, James B. Glattfelder, and Stefano Battiston ‘The Network of Global Corporate Control’ (available online at [http://arxiv.org/PS\\_cache/arxiv/pdf/1107/1107.5728v2.pdf](http://arxiv.org/PS_cache/arxiv/pdf/1107/1107.5728v2.pdf)) (Retrieved on 19 March, 2013). For a very brief discussion and analysis of the work see [http://www.huffingtonpost.ca/2011/10/24/super-entity-147-global-economy-swiss-researchers\\_n\\_1028690.html](http://www.huffingtonpost.ca/2011/10/24/super-entity-147-global-economy-swiss-researchers_n_1028690.html) (Retrieved 19 March, 2013); <http://thebluestates.wordpress.com/2011/10/25/40-of-worlds-wealth-controlled-by-super-entity-of-147-companies> (Retrieved 19 March, 2013); and <http://www.dailymail.co.uk/sciencetech/article-2051008/Does-super-corporation-run-global-economy.html> (Retrieved 19 March, 2013).

decisions and policies.<sup>4</sup> Whatever the purpose, money or credit is available mainly as a loan with interest, in truth also in many Islamic countries. The lending institutions, banks in particular, are often not concerned about whether their advanced loans are invested in productive activities or consumed; and neither is their interest linked to the outcome of any productive activity. Their interest is fixed and predetermined and must be paid irrespective of the fact that the advanced loans were intended for consumption, or the productive investments resulted in losses.<sup>5</sup> These, at least somewhat, irresponsible forms of financing have led to major problems and the

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<sup>4</sup> In their function as vehicles for the extension of developed country consumption patterns, multinational corporations act as a tool for exercising the indirect control associated with dependence (and intervention in all stages of the decision-making process of the host nation states). Dependence, in this context, implies some kind of unequal social relationship where one party enforces control over and acquires value from another (see Helge Hveem 'The Global Dominance System: Notes on a Theory of Global Political Economy' (Journal of Peace Research, 4, 1973) p. 333 pp. 319-340. Thus dependency means both a decrease in the ability to determine policy independently and an asymmetrical relationship where one social unit is able to control and constrain, either directly or indirectly, the development of another- mainly to the benefit of the former (see Stephen J. Kobrin 'Multinational Corporations, Sociocultural Dependence, and Industrialization: Need Satisfaction or Want Creation?' (College of Business, Tennessee State University, The Journal of Developing Areas, Vol. 13, No. 2, Jan. 1979) p. 116. However, it should be made clear that, as Cohen notes "dependence is a matter of degree rather than kind; economies are more or less dependent, rather than absolutely dependent or not" (see Benjamin J. Cohen 'The Question of Imperialism: The Political Economy of Dominance and Dependence' (New York: Basic Books, 1973) p. 191). Furthermore, as per Kobrin, dependence does not result from a deliberate policy of exploitation; it may well be structural (Stephen J. Kobrin 'Multinational Corporations, Sociocultural Dependence, and Industrialization: Need Satisfaction or Want Creation?' (College of Business, Tennessee State University, The Journal of Developing Areas, Vol. 13, No. 2, Jan. 1979) p. 116). However, Knorr disagrees with this idea. As per Knorr "we insist that there is no neocolonialism unless there is an effective use of power for deliberately establishing and maintaining an exploitative relationship" (see Klaus Knorr 'The Power of Nations: The Political Economy of International Relations' (New York: Basic Books, paperback ed., 1971) p. 255. As an example of dictating economic policies by the large money lenders, when Greece was recently in severely financial distress due to its huge sovereign debts, IMF, the European Central Bank and the European Commission proposed bailouts dictating several rounds of tough austerity measures that had to be implemented by Greece in return. The implementation of these measures could clearly contribute to a severe and prolonged economic contraction of the crisis-stricken Greece and severely affect the economic conditions of life of Greek citizens (see <http://www.bbc.co.uk/news/business-20706994>).

<sup>5</sup> See A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (Kuala Lumpur: A. S. Noordeen, 2005) Chapter 2, also available online at <http://users.bart.nl/~abdul/article4.html>

shortcomings found in modern finance.<sup>6</sup> This irresponsibility is similarly found in the world of investment. In order to earn more profits, investment firms and businesses are much more interested in investing their wealth in highly risky and speculative activities, no matter that these kinds of investments may create a lot of externalities and affect the economy systemically.<sup>7</sup> Moreover, in much the same way, irresponsible governments spend much of the accrued wealth in unnecessary areas, in particular for strengthening their own political ambitions.<sup>8</sup>

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<sup>6</sup> As per Zaman, irresponsible interest-based borrowing and lending leads to banking crises from time to time simply because fixed liabilities cannot be performed from an income stream which is flexible. Such crises bring about a lot of hardships and costs on all members of the public, but mostly on the poor. See Arshad Zaman and Asad Zaman 'Interest and the Modern Economy' (Islamic Economic Studies Vol. 8, Issue 2, April 2001) pp. 71-72. Ferraro and Rosser describe the current debt crisis happening in the world economy and the hardships inflicted on many segments of society by this crisis. See Vincent Ferraro and Melissa Rosser 'Global Debt and Third World Development' in Michael Klare and Daniel Thomas 'World Security: Challenges for a New Century' (New York: St. Martin's Press, 1994, pp. 332-355).

<sup>7</sup> Romano argues that the fail of market discipline is due basically to human greed. He believes that greed is a central factor that "transforms ... a moderately risky investment strategy into one of high-risk speculation" which in turn may cause devastating externalities especially systemic risk. See Roberta Romano 'A Thumbnail Sketch of Derivative Securities and Their Regulation' (Maryland Law Review, Vol. 55, 1998) p. 79. As per Schwarcz, discussing in the context of hedge funds, investment firms and businesses might indirectly cause banking systemic risk insofar as these firms and businesses lack of regulation enables them to make risky investments, including risky loans. This dilemma, however, does not result from the nature of these investment firms but, rather, out of their unregulated nature, enabling them to do risky investments if they intend to do so. See Steven L. Schwarcz 'Systemic Risk' (The Georgetown Law Journal, Duke Law School Legal Studies Paper No. 163, Vol. 97, Issue 1, 2008) p. 202, fn. 42.

<sup>8</sup> When public elections and also economic downwards create public demand for immediate actions, politicians focus on demand-side ("Short-Run Politics") more than supply-side ("Long-Run Productivity") policies. Demand-side policies are usually taken to grant immediate benefits on specific interest groups in order to attract more votes in favour of the politicians, while supply-side policies are usually aimed at increasing the productive capacity of the economy to promote prosperity of the members of the public. Supply-side policies require new initiatives and investments that can take years to generate new income. Also, since effective supply-side policies impose immediate burdens on politically influential groups, these policies are often resisted by these groups. See Dwight R. Lee 'The Keynesian Path to Fiscal Irresponsibility' (Cato Journal, Vol. 32, Issue 3, Fall 2012) pp. 483-484.

### **1.2.2 Questions**

The main questions that this research tries to answer are: is there an alternative solution? If any, what is a solution? What should be the ultimate goal of the new alternative solution and what are the foundational theory and fundamental principles and policies on the basis of which the new model/system should be built up? What is meant by justice in general and social justice in particular in economic and financial context, and how can it be achieved, if at all? What is meant by wealth and how is it to be distributed in human society? What is meant by the rights and duties of human beings? What is the relationship between rights and duties in a general framework and the relationship between benefits and burdens particularly in an economic context? What are the reasonable and legitimate economic, business, and financial needs of humanity and should they be responded to? What does reasonable and legitimate mean in this context? What are the necessary and major concepts, products, services and institutions of the alternative model, responding to different legitimate and reasonable needs, including: profit-making, not-for-profit, microfinance, intermediary and risk hedging needs? How should the whole system be run and controlled in order to achieve a more balanced and stable system?

### 1.2.3 Necessity and Importance

Modern financial systems have failed to respond to the reasonable and legitimate economic and financial needs of humanity in a fair, just, and balanced manner and consequently have failed to bring about lasting social prosperity and meet social justice. That is why academics and policymakers largely agree that it is necessary to look for a new paradigm.<sup>9</sup> Undoubtedly, the new paradigm has to respond to all reasonable and legitimate economic and financial needs of individuals, businesses, not-for-profit organisations and governments in a fair and just manner in order to achieve social welfare and social justice. As will be discussed later, academics and policymakers have in recent years dedicated much effort to finding a new solution but have been unable to introduce a new foundational theory that would rival the theories underpinning Capitalism and Marxism. To date academic scholarship and regulatory reforms have focused only on some aspects of the economy especially the banking system, capital markets, and taxation and risk insurance sectors. Therefore, the demands of policymakers and the strength of public opinion especially from the lower and middle classes provides the impetus to this research and for finding a lasting solution.

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<sup>9</sup> As per Sklair “capitalism cannot provide the conditions for most people on the planet to have satisfying lives and that alternatives ... are urgently required”. As per him, the most effective alternative will be a focus on the globalization of human rights and responsibilities and to achieve this, humanity will have to move on from the dominant capitalist system. See Leslie Sklair ‘Capitalist Globalization: Fatal Flaws and Necessity for Alternatives’ (Brown Journal of World Affairs, Volume 13, Issue 1, Fall/Winter 2006) pp. 29 and 35. For more about the efforts that have been made in practice to develop new economic thinking see the Institute for New Economic Thinking’ mission at [www.ineteconomics.org](http://www.ineteconomics.org)



#### 1.2.4 Aim

The aim of the research project is to suggest a new solution to contribute to the academic scholarship dealing with the alleviation of poverty, fair and just distribution of wealth, financial stability and social prosperity. It is intended to introduce a new direction that the economic, business and financial policymakers may adopt and follow irrespective of their social, legal or religious backgrounds.<sup>10</sup> In the suggested model, social justice and equitable distribution of wealth prevails over efficiency rules.

It should be acknowledged that since the primary aim of the research is to provide a systemic approach for a new alternative model, it must inevitably cover all major elements of the system. This thesis tries to address and discuss almost all necessary elements of the model but without going into great detail about every single element or comparing them with their counterparts in different legal, economic and financial systems. However, some key concepts such as right (*haq*), justice, balance, wealth, asset, limited liability, *musharakas* (partnership-like structures), *waqf* (trust-like structure), *zakat* (tax-like concept), public finance, and the legal nature of money and electronic currency have been dealt with in great detail and have been compared in different Islamic schools of thought more than other elements of the model. Some elements of the model do require further scholarly research and also comparative studies. A list of topics that require further academic study is provided in the conclusion of the research project.

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<sup>10</sup> It may be argued that religious-minded policymakers as well as individuals would resist the application of any rules that had not originally arisen from the teachings of their religion but had been borrowed and transformed from the secular Western world. However, research conducted by Foster has concluded that this has not been problematic, at least in the Islamic world. Many Islamic countries as well as Muslims have adopted and followed many Western-style concepts and institutions. Foster calls this phenomenon “the Acceptance Mentality” i.e., accepting with no practical resistance. See Nicholas HD Foster ‘Islamic Perspectives on the Law of Business Organisations II: The Sharia and the Western-style Law of Business Organisations’ (European Business Organization Law Review, vol. 11, issue 2, 2010) pp. 279-282.

### **1.3 Outline of the Thesis**

The thesis is organised in the following manner. The first chapter deals with the background, context and methodology of the research as well as all three parts of the first tier of the model (the ultimate aim, foundational theory, and fundamental principles and policies), after giving a general introduction and explaining the problems, questions, necessity, importance and aim of the research project. The second chapter offers some key concepts and their implications in Islamic law. The third chapter deals with the first part of the second tier of the model i.e., distribution of primary wealth, which is followed by an introduction to the distribution of subordinate wealth including the general law of transactions. The fourth chapter deals with part two of the second tier of the model i.e., profit-making products and collective schemes, after distinguishing different needs and purposes in the context. The fifth chapter covers parts three, four, and five of the second tier of the model i.e., profit-free, philanthropic, and microbusiness facilities. The sixth chapter deals with part six of the second tier of the model, i.e., intermediary tools and services. The seventh chapter covers part seven of the second tier of the model, i.e., risk protection tools and services. The eighth chapter deals with the last tier of the model, i.e., the superstructure and political regime of the model (covering the House of Wealth and the House of Market Control, "HMC"). Finally, the thesis concludes with the ninth chapter.

## 1.4 Background and Context

In the aftermaths of economic and financial crises- leaders, policymakers and thinkers always suggest that the crisis requires the re-examination of basic assumptions of modern economic and financial systems. In this regard, the major assumptions, such as the rationality, risk and reward structures and distribution of benefits are reassessed and very diverse opinions on how to construct a new, sustainable and just economic and financial system have been offered.<sup>11</sup>

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<sup>11</sup> For an interesting explanation in this regard see Kevin T. Jackson 'The Scandal Beneath The Financial Crisis: Getting a View from Amoral-Cultural Mental Model' (Harvard Journal of Law & Public Policy, Vol. 33, pp. 735-778) (also available at <http://www.harvard-jlpp.com/33-2/735.pdf>). For example, according to Jackson (p. 778), "what is lacking in the received narratives of the financial crisis is a robust conception of moral virtue, human dignity, and the common good". Jackson points out that market failure occurs mainly due to a more general failure of responsibility, not only in business associations but also in the general culture. On this basis, according to him, the big lessons that can be learned by policy makers and regulators are to be found in focusing on moral reform rather than introducing new rules and regulations. As per Jackson, virtue cannot be substituted by regulation.

The most recent financial crisis, which triggered also an economic crisis<sup>12</sup>, has again attracted the wide attention of policymakers, academics, and industry actors to consider the feasibility and sustainability of the modern economic and financial system especially its resistance against financial crises and its fairness regarding the distribution of wealth. Some think that there is no choice but to follow the laws and

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<sup>12</sup> Usually, the success or failure of any economy is determined by the degree of success of its financial system simply because modern economies are finance-dominated ones. That is why the focus of the research model is on the financial sector among other sectors (i.e., economic and business sectors). In the modern sense, every developed financial system consists of capital markets and financial institutions. The “Anglo” model is often known for focusing more on capital markets. The “Continental” model is frequently characterised as being more suspicious of capital markets and dependent more on institutions, in particular banks. Political economy literature contrasts Anglo-Saxon model with the Continental model typical of Germany. In the political economy scholarship, the appeal of the Continental model lies in the bank-based financial system and Anglo-Saxon model is characterised by the ideology of a well-developed and liquid capital market i.e., capital market-based model. For more in this regard see John Zysman ‘Governments, Markets and Growth’ (Cornell University Press, 1983); Wolfgang Streeck and Kozo Yamamura ‘The Origins of Neoliberal Capitalism’ (Ithaca, Cornell University Press, 2005); Chuck C. Kwok and Solomon Tadesse ‘National Culture and Financial Systems’ (Journal of International Business Studies, Vol. 37, March 2006); Iain Hardie and David Howarth ‘Die Krise but not La Crise? The Financial Crisis and the Transformation of German and French Banking Systems’ (Journal of Common Market Studies, Vol. 47, November 2009); B. Tricker ‘Corporate Governance: The Ideological Imperative’ in H. Thomas and D. O’Neal ‘Strategic Integration’ (SMS, Wiley, Chichester, 1999). UK and the US are usually considered two exemplary capital market-based national financial systems. However, an ever-increasing literature on the political economy of European finance shows the weakness of the classical view of the UK as an obviously capital market-based and Germany as a clearly bank-based system. See Iain Hardie and David Howarth ‘What Varieties of Financial Capitalism? The Financial Crisis and the Move to Market-Based Banking in the UK, Germany and France’ (Paper presented at the ISA Conference 2010, New Orleans, 2010) and also see Chris Howell ‘The British Variety of Capitalism: Institutional Change, Industrial Relations and British Politics’ (British Politics, Vol. 2, July 2007, pp. 239-264). Also, it should be considered that this approach is too basic: banks need markets (e.g., to raise capital) and markets need facilitating institutions (e.g., clearing infrastructure and underwriters). Many continental banks are main market players, particularly in derivatives and, on the other side, community banks in the US are the backbone of micro-business finance. See Iain Hardie and Sylvia Maxfield ‘What Does the Global Financial Crisis Tell Us About Anglo-Saxon Financial Capitalism?’ (Paper Prepared for Workshop on The Financial Crisis, EMU and the Stability of Currencies and the Financial System, University of Victoria, October 1, 2010).

claims of capitalism.<sup>13</sup> Others have argued for the necessity of a new alternative to the prevalent capitalist system. It has been argued that it is time to revive and implement Socialism in lieu of Capitalism.<sup>14</sup> Still others have voiced their support that the Islamic

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<sup>13</sup> Rejecting the maximizing imperatives at the central core of capitalism, McKibben in his book titled 'Deep Economy: The Wealth of Communities and the Durable Future' suggests a case for moving beyond "hyper-individualism" and instead focusing on local economies. But, however, he does not propose any fundamental structural change. "Shifting our focus to local economies," he mentions, "will not mean abandoning Adam Smith or doing away with markets. Markets, obviously, work." In his essay titled "The Greenback Effect: Greed Has Helped Destroy the Planet- Maybe Now It Can Help Save It" McKibben takes his market belief still further strong. "Markets are powerful" and they solve all problems, he says. All we must do is to reform our use of them by building in the information they need to function to address shortcomings and work properly. To those who believe that we must go "beyond capitalism" to solve our problems, McKibben has this answer: we cannot wait for structural change. It takes too long and we simply cannot risk delay. "Markets are quick" he writes. "Given some direction, they'll help". See Bill McKibben 'Deep Economy: The Wealth of Communities and the Durable Future' (New York: Times Books, 2007) pp. 2 and 105; Bill McKibben 'The Greenback Effect: Greed Has Helped Destroy the Planet- Maybe Now It Can Help Save It' (Mother Jones, May/June 2008).

<sup>14</sup> Schumpeter, in his well-known work contribution to political economy in 1942, argues for capitalism's inability to survive and warns of the inevitable coming of socialism. See Joseph Schumpeter 'Capitalism, Socialism, and Democracy' (Taylor & Francis e-Library, 2003). His main argument begins with Part II of his book "Can Capitalism Survive?". Through the first chapters of Part II, Schumpeter criticises mainstream economics and in the last chapters of Part II discusses why capitalism cannot survive. Part III of the book starts dealing with "Can Socialism Survive?" and of particular interest is chapter XXVI of Part III in which Schumpeter argues why a socialist economy is a feasible proposition. However, it should be noted that, as per Ravier, Schumpeter does not argue, as Marx did, that capitalism must fail due to the inherent contradictions within the capitalist structure of production and consumption. Schumpeter's viewpoint is quite the opposite. He believes that it is the very success of capitalism at creation of wealth and raising the living standards of people that finally undermine the social institutions that stood to protect it. The gradual disappearance of those institutions unavoidably creates conditions under which capitalism would find it harder to last. Furthermore, the disappearance of the essential social framework causes the social forces turn to socialist approaches and practices across the society. See Adrian O. Ravier 'Capitalism, Socialism and Public Choice' (Libertarian Papers, Vol. 2, Issue 26, 2010) pp. 1-2. In addition, as per Wolff, the late-2000s crisis, especially in the US and Western Europe, has renewed the criticism of capitalism as a viable system. Since 2007, when the crisis started, social movements e.g., Occupy Wall Street have been much quicker than was the norm for social movements in the last decades and they explicitly target capitalism. Request for Marx's writings have risen. New fresh interest in socialism and socialist political parties is greatly in evidence. Anarchist refusals of capitalism are in fashion. Public view polls evidence widespread hostility towards capitalism and equally significantly good attitudes towards socialism. See Richard Wolff 'Alternatives to Capitalism' available at <http://www.rdwolff.com/content/alternatives-capitalism>. Published On February 11, 2013 (will appear in Critical Sociology Journal in May 2013).

model would be the best solution.<sup>15</sup> Particular attention is devoted to Islamic economics and finance.

Historically, between the eighth and eleventh centuries when the Church in the West strictly prohibited the making of interest, financial institutions practising in the West and in the Islamic world were quite similar. The similarity of these two systems, however, began to diverge gradually up to the present age. The Catholic Church in the West devised and practised the very first concept of “corporation”, which was later used by many others, such as universities and merchants – finally taking shape into its most developed variant, the incorporated joint-stock company. Corruption and the abuses of the Inquisition in the practises of the Catholic Church led to Protestantism in the sixteenth century. Important teachings in Protestantism, and ones which attacked the Catholic Church, were that “hard work”, “honesty”, and a “fully-merited business and profit” should be regarded as virtuous deeds. Two centuries later, a new

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<sup>15</sup> According to Al-Hassani, human being is naturally motivated to pursue his/her self-interest, which may often be in conflict with the interest of the public. This undeniable conflict is the main cause of many social and economic difficulties from which human societies have no way to avoid. The history of humanity has proved that none of materialistic economic philosophies have been able to provide a proper lasting solution in this regard. As per Al-Hassani, this is due to the lack of the role of religion (*din*) in these materialistic thinkings. That is why, as per him, Islam, being the *din* of God (*Allah*), is the “one and only source which can provide *Iqtisad* [economy] with a unique solution: to reorient man’s motivations and direct all his individual interests in such a way as to satisfy those of the public”. This can be accomplished because Islam can trigger the spiritual capacities of human being which provide him with a new perception of life and existence. See Bakir Al-Hassani ‘Iqtisad: The Islamic Alternative for Economics’ (Lanham: IMAMIA Centre, 1988) p. 45. Also, as per Chapra, the simultonous focus on both the material and the spiritual aspects of human life is a unique feature of Islamic economic system. The spiritual and the material are so strongly connected with each other that they together may provide a source of mutual stength and human welfare and, on the other side, a neglect of either cannot lead to prosperity of mankind. As per Chapra, since capitalism and socialism are both originally “secular and either a-moral or morally neutral”, the mentioned synthesis of the material and the spiritual is missing in both of them. See M. Umar Chapra ‘The Economic System of Islam: A Discussion of its Goals and Nature’ (London: The Islamic Cultural Centre, 1970) pp. 8-9. As per Evans “the practicalities of the present economic situation require the observer to consider that Shari’a-compliant financing may present an appealing alternative to the apparent failures of Western financial systems”. See McKean James Evans ‘The Future of Conflict between Islamic and Western Financial Systems: Profit, Principle and Pragmatism’ (University of Pittsburgh Law Review, Vol. 71, Issue 4, Summer 2010) p. 836.

movement named the “Enlightenment” began that not only discarded almost all the values taught by the Church, e.g., the moral values which had controlled business conduct for centuries but also criticised the religious aspect itself. Consequently, a new single-minded form of Capitalism, in the modern sense, emerged with its most well known tenets of uncontrolled maximisation of profit, overconsumption, and exploitation of labour. In contrast, the major deviations in the early classical Islamic economic policy are significant divergences over the same period in land-ownership system, fixed wage rate and remuneration for labour on an hourly, daily, weekly, monthly, or annual basis as well as the introduction of the concept of limited liability into a business context, improper taxation policy, over-interference of the state in the economy, and conventionalisation (i.e., Westernisation) reality, that is to say a mere mimicking and imitation of Western finance in the Islamic world especially in the present age, whilst failing to restore the lost Islamic heritage.<sup>16</sup> It is argued that with a time-lag of some 200 to 450 years, when the Church in the West applied the prohibition of interest (between the eighth and eleventh centuries), Western economies adopted institutional borrowing from the Islamic world rather than inventing it themselves. This is the main reason why Islamic and Western economies had significantly similar institutions. It is said, however, that in the area of public finance, autonomous independent city-states in the West with different political

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<sup>16</sup> For a similar approach and also for more detail in this regard see Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) pp. xx-xxvi.

systems invented institutions which were quite different from those implemented in the centralised Islamic empires.<sup>17</sup>

In modern sense, as far as the international<sup>18</sup> and Western<sup>19</sup> financial system is concerned, the practical reaction and problem solving attempts as well as intellectual efforts to deal with the problems created by the financial crises have focused

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<sup>17</sup> For more detail see Gene W. Heck 'Charlemagne, Muhammad and the Arab Roots of Capitalism' (Berlin: De Gruyter, Studien zur Geschichte und Kultur Des Islamischen Orients, 2006); Murat Cizakca 'A Comparative Evolution of Business Partnerships, Islamic World and Europe with Specific Reference to the Ottoman Archives' (Leiden: E.J.Brill, 1996); Murat Cizakca 'Cross-Cultural Borrowing and Comparative Evolution of Institutions between Islamic World and the West' (In S. Cavaciocchi (Ed.), also available at [www.mcizakca.com](http://www.mcizakca.com)); Murat Cizakca 'A History of Philanthropic Foundations, The Islamic World From the Seventh Century to the Present' (Istanbul: Bogazici University Press, 2000).

<sup>18</sup> At international level, most initiatives have focused on the effective regulation and control of international financial markets especially banking institutions by an international financial authority. This has been largely due to the emergence of a single global market in financial services and also the devastating externalities and systemic risks that increasingly complex international banking and financial conglomerates can create in the economic and financial systems if they go bankrupt. Some leading scholars in the West have argued for such an extensive international response and have analysed the adopted structure and regulatory framework in this regard (of major international efforts in this regard is Basel Committee on Banking Supervision I, II, and now III). In great detail see George Alexander Walker 'International Banking Regulation, Law Policy & Practice' (Kluwer Law International, 2001). In his book, Walker examines the inherent problems in relation to cross-sector methods of regulatory policies and argues for a new 'larger integrated response' to cope with the serious concerns of the 'single global market of the new millennium'. In this regard, Walker offers several alternatives: 'Global Authority or Committee Revision', 'Separate Co-ordinating Committee or Agency', and 'Committee Development Programme' (pp. 355-362).

<sup>19</sup> Whenever the research project refers to Western concepts, it mainly means those concepts that are practised in US and English jurisdictions.



extensively on “financial regulation”<sup>20</sup> initiatives rather than any thoughts of an alternative financial model.<sup>21</sup>

A spirit of experimental pragmatism has been the main intellectual force behind financial regulation in the US - what works in shoring up the system? In general, it starts with the premise that the market has failed, an analysis is done of this failure, and an attempt to fix it is made. Basically, legislators and regulators in the US have been more interested in preserving the capitalist system. The best examples of this were the reforms of the 1930s which did not give way to the widespread socialist attitude of the time. Public anger of the financial class and lack of knowledge among the general population about the financial system’s functions have, over time, led to

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<sup>20</sup> As per Véron, financial reform has been a major focus of the initial global policy reaction to the late-2000s financial turmoil and it can be said that the mentioned crisis has been transformational point for financial regulatory policy, at least in the US and Europe. See Nicolas Véron ‘Financial Reform after the Crisis’ Chapter 2 in Barry Eichengreen and Bokyeong Park ‘The World Economy after the Global Crisis: A New Economic Order for the 21st Century’ (Hackensack, NJ: World Scientific Pub., 2012) p. 7. As per Rottier and Véron, at the first G-20 summit in November 2008, more than four-fifths of the action items in the summit’s final declaration were regarding financial regulation and only about one-fifth on broadly related subjects such as tax, controls on capital flows, actions to fight against terrorism financing and money laundering, and general reform of the Bretton Woods Institutions. See Stéphane Rottier and Nicolas Véron ‘An Assessment of the G20’s Initial Action Items’ (Brussels: Bruegel, Bruegel Policy Contribution, Issue 2010/08, September 2010) p. 2.

<sup>21</sup> For an effective solution in modern economies, some leading scholars have suggested the necessity of a combination of market forces (i.e., industry practices) and governmental intervention (i.e., regulation); although they acknowledge that this approach may still not work very well because of the problems of regulators’ limited insight into the market and also the invisible hands in the market. They argue for functionalism rather than formalism and realism. As per these scholars, “law and ...” movements e.g., the “law and economics” movement (the movement that tries to examine the legal rules and their implications from the viewpoint of economic efficiency and wealth distribution) has now become popular where there is a greater interest in more empirical research to prepare legislation and check its effects after its application in the society. See Jan H. Dalhuisen ‘Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law’ (Hart Publishing, vol. 1, 4<sup>th</sup> edition, 2010) pp. 126-132, 257-262. For more see also R. A. Posner ‘Economic Analysis of Law’ (Aspen Publishers Inc., 8<sup>th</sup> edition, 2010); WM Landes and RA Posner ‘The Influence of Economics on Law: A Quantitative Study’ (Journal of Law and Economics, vol. 36, 1993) p. 385; RH Coase ‘The Problem of Social Cost’ (Journal of Law and Economics, vol. 3, 1960) p. 1.

laws and regulations that are not fully thought through. Rules against short-selling<sup>22</sup> and the ever increasing criminalisation of financial regulatory enforcement<sup>23</sup> are good examples of this. Beginning in the 1960s and maturing in the 1970s and 1980s, a

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<sup>22</sup> Section 10(a)(1) of the 1934 Act states that: "It shall be unlawful for any person ... to effect a short sale ... in connection with the purchase or sale of any security registered on a national securities exchange ...". This Section was first implemented by the SEC in early 1938, through the introduction of rule 10a-1 of the 1934 Act, known as the "uptick rule". See Erik R Sirri 'Regulatory Politics and Short Selling' (University of Pittsburgh Law Review, Vol. 71, Issue 3, Spring 2010) p. 522.

<sup>23</sup> Of major reforms of the 1930s are the enactments of six major federal securities acts which contain provisions imposing heavy fines or imprisonment or both on a number of prohibited conducts. The common feature of all these federal securities acts is that one who "wilfully" violates any of the provisions of the statutes and regulations thereunder commits a criminal offense. The *1934 Act*, known as the "truth in securities" law, imposes a disclosure obligation on issuers in order to prevent fraud and misrepresentation in the primary distribution of securities. The *Securities Exchange Act of 1934* regulates secondary trading in the securities markets and governs the operations and activities of dealers and brokers. It imposes direct governmental regulation such as banning the manipulation of the prices of securities traded on the exchanges, prohibiting manipulative or deceptive devices and practices in the sale or purchase of securities on exchanges, and restricting severely insider trading. It also involves a resort to SEC-supervised self-regulation of the securities exchange markets. The *Public Utility Holding Company Act of 1935* which empowers the SEC to regulate interstate public utility holding company systems which are involved in the electric utility business or in the retail distribution of natural or manufactured gas. The main purpose of the Act is to limit the utility holding company's operations to an integrated system by requiring physical integration and corporate simplification of the system. The *Trust Indenture Act of 1939* introduces certain statutory standards to trust indentures according to which bonds, debentures, notes and similar debt securities are offered for public sale. This Act regulates heavily the character and conduct of the indenture trustee. The *Investment Company Act of 1940* requires the registration and disclosure of the financial condition and investment policies of publicly held companies involved in the business of investing, reinvesting and trading in securities. The Act tries to protect the interests of all the investment company's security holders by preventing changes in investment policies without shareholder approval, by regulating the custody of company assets, and by forbidding transactions between the company and its fiduciaries without SEC approval. The complementary *Investment Advisors Act of 1940* regulates individuals involved in the business of providing advice, analysis or reports on securities by requiring their registration. The Act contains anti-fraud provisions and imposes a duty on the investment advisor to maintain books and records which are subject to inspection. It also requires the advisor to reveal the nature of her interest in any transaction she has executed on behalf of her client. The original criminal sanctions imposed on offenders by the above mentioned six federal securities acts have remained intact to the present time. It is noteworthy that there are several other federal criminal statutes which may, and usually do, apply in criminal prosecutions in the securities area. See James R. Gillespie 'Securities and Exchange Commission and Criminal Violations of the Federal Securities Laws' (Indiana Legal Forum, Vol. 1, Issue 1, Fall 1967) pp. 154-156, 161, 163, and 180.

movement pushing for deregulation<sup>24</sup> started advocating the efficacy of markets as allocators of capital and disseminators of information and the inefficiencies of government regulation and interference in the economy.<sup>25</sup> Frequently cited as an example of deregulation in practice, the Financial Modernisation Act of 1999 (the Gramm-Leach-Bliley Act (GLB)) was a complex and interesting piece of American regulation. However, the dominance of deregulation has now been undermined by the

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<sup>24</sup> See George Alexander Walker 'Financial Markets and Exchanges' in Michael Blair QC, George Walker and Stuart Willey 'Financial Markets and Exchanges Law' (Oxford University Press, 2<sup>nd</sup> edition, 2012, pp. 3-43) p. 4. According to Walker, this deregulation movement that was followed by many countries from the late 1980s and early 1990s onwards led to the creation of a truly global financial and capital marketplace. As per Walker, the main cause to this fundamental change was significant increases in the growth and appetite for capital and investment at the national level and also internationally. The cross-border development of banking business, and then insurance and securities, supported by technological advances and other computer hardware and software support were also reasons for the emergence of this truly global financial market.

<sup>25</sup> During this time, the federal government of the United States eliminated or substantially reduced the general controls or guidelines on prices and wages throughout the economy including financial sector. Changes in financial regulation were compelled by significant developments in the financial markets. Commercial and savings banks had been subject to interest rate restrictions on their deposits since the 1930s. These restrictions have caused considerable problems only when market interest rates soared rapidly, first in the late 1960s and also in the late 1970s. Small depositors were especially suffered losses by these ceilings on interest rates. The development of the money market mutual funds in the 1970s offered depositors deposit-like accounts with higher market interest rates and this fact led to a significant reduction of deposits in the banking system. Congress consequently reacted to these developments in 1980 by authorising the gradual removal of interest rate ceilings by 1986. Another Act in 1982 allowed banks to introduce new types of accounts to both small and large depositors. These new types of accounts became very popular and increased the interest payments to depositors with no substantial effect on interest rates to borrowers. Other provisions of the 1982 Act authorised the acquisition of a failed bank by an out-of-state bank or by a bank of a different type. See William A. Niskanen 'Economic Deregulation in the United States: Lessons for America, Lessons for China' (Cato Journal, Vol. 8, Issue 3, Winter 1989) pp. 657 and 662. In his paper (p. 668), Niskanen concludes that the path to deregulation is not without difficulties, but it is the road to economic development. He writes, a government that represents the nation, rather than the interests of certain groups, will choose this road to prosperity.

recent financial crisis.<sup>26</sup> The new Act in the US after the late-2000s financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA),<sup>27</sup> attempts to correct one of the perceived flaws in the GLB by giving the Federal Reserve authority to systemically regulate major banking institutions and other financial firms as a whole.

Similar to the US's approach as explained above, the UK's response to the systemic financial problems has focused more on financial regulation rather than on

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<sup>26</sup> Some economists, legal scholars and others have argued that deregulation may precede and cause financial turmoils or contribute to their severity by leaving economies insecure when a financial crisis occurs. For some literature arguing that deregulation contributed critically to current global financial turmoil see James Crotty 'Structural Causes of the Global Financial Crisis: a Critical Assessment of the New Financial Architecture' (Cambridge Journal of Economics, Vol. 33, 2009) pp. 563-580 (as per Crotty at p. 575 "the severity of the global financial crisis and the global economic recession that accompanied it demonstrate the utter bankruptcy of the deregulated global neoliberal financial system and the marketism it reflects"; Patricia A. McCoy et al. 'Systemic Risk through Securitization: The Result of Deregulation and Regulatory Failure' (Connecticut Law Review, Vol. 41, Issue 4, 2009) pp. 493-541 (as per McCoy et al at p. 493, deregulation policy and regulatory failure with respect to asset-backed securities markets created a bubble in housing industry and massive fraud in this market); Brian J. M. Quinn 'The Failure of Private Ordering and the Financial Crisis of 2008' (New York University Journal of Law & Business, Vol. 5, Issue 2, Summer 2009) pp. 549-616 (according to Quinn at p. 597, financial crisis of 2008 proved that that "the efficient capital markets hypothesis has run its course as an animating principle for deregulatory trend of the past three decades". Still other scholars have laid the fault not on less or de-regulation, but instead on the failure of existing and also newly introduced regulations and regulatory enforcement regimes. Some scholars argue that the crisis rooted not in deregulation but stemmed from failed or flawed existing regulation. For instance, see Charles W. Calomiris 'Another "Deregulation" Myth' (American Enterprise Institute for Public Policy Research, On the Issues, Oct. 2008) available at [http://www.aei.org/files/2008/10/29/20081029\\_5723624OTICalomiris\\_g.pdf](http://www.aei.org/files/2008/10/29/20081029_5723624OTICalomiris_g.pdf) (Retrieved on March 9, 2013). Calomiris argues that the 2004 change in the SEC's rule on net capital which proved to be unsuccessful in fixing the problems at Lehman Brothers and Bear Stearns is not an example of deregulation but failure of new regulation which contributed to the severity of the late-2000s financial crisis.

<sup>27</sup> The DFA was signed into law by President Obama on July 21, 2010 after a year-long process. The DFA mainly introduces a framework to be built on by the financial regulators. It is argued that it will take many more years for the regulatory organism to fully adapt to the reforms under the DFA.

planning for an alternative financial model.<sup>28</sup> The U.K. Tripartite Authorities namely H.M. Treasury, Bank of England, and the Financial Services Authority, worked together to contain the financial crisis in the United Kingdom and of important measures they took in this regard were the use of Bank of England as lender of last resort to provide necessary loans to failing banks, increasing the coverage limit of the country's deposit insurance system, widening the use of collateral the Bank of England would accept for liquidity, extending lending to the economy, limiting bonuses, government intervention with blanket guarantees and recapitalisation, and the introduction of the asset protection scheme.<sup>29</sup> More specifically, as evidence of regulation initiative in the UK, following the late-2000s financial crisis, the UK government enacted the Banking Act 2009 which introduced a "Special Resolution Regime" (SRR) for banks in financial difficulties and modified insolvency and administration law as it applies to banks. It also amended the "Financial Services Compensation Scheme" (FSCS). Furthermore, the Financial Services Act which came into force from 1 April 2013 delivers fundamental reform of financial regulation in the UK. It introduces a clear and consistent regulatory framework, replacing the uncertainty and insufficiency of the failed Tripartite system.

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<sup>28</sup> For example, after Northern Rock was faced by the liquidity crisis in 2007, it was forced to accept emergency funding from the Bank of England and later was taken into public ownership through its acquisition by the Treasury. The concerns surrounding Northern Rock crisis were considered by the House of Commons Treasury Committee in an initial report on "The Run on the Ruck" on 26 January 2008. An exploratory discussion paper on "Banking Reform: Protecting Depositors" was issued by the Tripartite Authorities on October 2007 and this was followed by an official consultation document on "Financial Stability and Depositor Protection: Strengthening the Framework" on 30 January 2008. See George Alexander Walker 'Banks and Banking' in Michael Blair QC, George Walker and Robert Purves 'Financial Services Law' (Oxford University Press, 2<sup>nd</sup> Edition, 2009, pp. 681-752) pp. 747-750. See also George Alexander Walker 'Northern Rock Falls' (Bankers' Law, Vol. 2, Issue 2, 2008) pp. 4-12; George Alexander Walker 'The Deconstruction of Financial Risk' (Palgrave Journal of Banking Regulation, October 2008) 1, 2; and George Alexander Walker 'Credit Crisis- Regulatory and Financial Systems Reform' (Butterworths JIBL, November 2007) pp. 567-572.

<sup>29</sup> For a detail explanation of each of these measures see Dalvinder Singh 'U.K. Approach to Financial Crisis Management' (Transnational Law & Contemporary Problems, Vol. 19, Issue 3, Winter 2011) pp. 869-870.

This Act is mainly made up of amendments to the Financial Services and Markets Act 2000 (FSMA). The Act provides regulators with broad powers to combat future risks to financial stability and to ensure that consumers will be treated fairly. It takes significant steps to direct the focus of regulators to rebuild a confident competition in a banking sector that has become too concentrated. The Act gives the Bank of England responsibility for protecting and enhancing financial stability through converging macro and micro prudential regulation. The Act abolishes the Financial Services Authority (FSA) and introduces a new regulatory architecture consisting of the Financial Policy Committee (FPC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA); and furthermore the Act empowers authorities to go beyond “tick-box” compliance and furthers a regulatory culture of judgment, expertise and proactive interventionist approach.<sup>30</sup>

In modern sense, as far as the initiative of Islamic banking and finance concerned, it was first emerged in the 1950’s and the first group of Islamic investment banks were developed in Egypt and Malaysia in the early 1960’s.<sup>31</sup> Oil revenue shocks in the 1970s caused a wealth transfer that made contemporary Islamic banking and finance a viable reality. In modern Islamic banking and finance, two distinct approaches rival each other: *Sharia*-compliant (quasi-Islamic) approach and *Sharia*-based (Islamic) approach.<sup>32</sup>

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<sup>30</sup> For more in this regard see HM Treasury website at [http://www.hm-treasury.gov.uk/press\\_126\\_12.htm](http://www.hm-treasury.gov.uk/press_126_12.htm). On 19 December 2012, the Financial Secretary to the Treasury, Greg Clark, said that “I am delighted that the Financial Services Bill has received Royal Assent today [and]... these reforms [under the Financial Services Bill] as well as those in the forthcoming Banking Reform Bill- can help rebuild confidence and trust.”

<sup>31</sup> See Ali Malik, Muhammad Shaukat Malik, Haider Shah ‘An Analysis of Islamic Banking and Finance in West: From Lagging to Leading’ (Asian Social Sciences, vol. 7, no. 1, January 2011) p.180. For more detail see also Y. Karbhari, K. Naser & Z. Shahin ‘Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK.’ (Thunderbird International Business Review, 2004) pp. 46, 5, 521-543.

<sup>32</sup> See International Organization of Securities Commissions (IOSCO) ‘Islamic Capital Market Task Force’ (2004) pp. 5, 14.

The *Sharia*-compliant approach which is also known as the “Conventionalisation or Westernisation” approach creates the products by first identifying the modern financial products and services and then removing or modifying any non-*Sharia*-compliant elements to make them acceptable instruments from the viewpoint of *Sharia*.<sup>33</sup> It is criticised that mainstream Islamic banking and finance does not reflect the inner dimensions of the Islamic tradition and that not only is not established based on classical Islamic jurisprudence, but it also deviates from the “spirit” of *Sharia* if not the letter. It has been convincingly argued that this practice of modern Islamic banking and finance leads to considerably “high costs, lower profits, and most importantly, a dilution of respectability”.<sup>34</sup> The main reason that modern Islamic financial products (i.e., *Sharia*-compliant instruments) are losing their respectability is that the contemporary Islamic banking and finance industry has been more interested in ‘creative lawyering’ and/or ‘financial (re)engineering’ rather than going forward on the basis of any organic *fiqh* (Islamic jurisprudence) arising functionally out of the objectives of *Sharia* (*Maqasid al-Sharia*). The so-called rates of profit in many of the modern “*Sharia*-compliant” products are benchmarked to the prevalent interest rate in the monetary market such as LIBOR. These *Sharia*-compliant financial products involve the “exact same transfer of credit and risk” and often require the same types of security to ensure their performance.<sup>35</sup> It is for this reason that the modern *Sharia*-

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<sup>33</sup> For more see Mahmoud A. El-Gamal ‘Islamic Finance: Law, Economics, and Practice’ (Cambridge University Press, 2006) p. 8. As per El-Gamal, the starting point in contemporary Islamic banking and finance is modern financial practices, from which it moves away insofar as some modern practices are deemed forbidden in *Sharia*. Notably, from the point of view of *Sharia*, it is commendable to follow the applicable canons (i.e., law of the land) so long as canons do not contravene the requirements of *Sharia*. However, as per more strict interpretations, some Ulama (leading *Sharia* experts) believe that any law of the land is to be checked by reference to *Maqasid al-Sharia* i.e., Objectives of *Sharia*.

<sup>34</sup> A major criticism of Islamic banking and finance is the incremental transaction costs, i.e., the so-called “price of being Muslim” and hazards associated with irrational pietism.

<sup>35</sup> See Caner K. Dagli ‘Islamic Law, Shariah-based Finance, and Economics’ (College of the Holy Cross: pre-publication draft) pp.12-13.

compliant products are facing an ever increasing *Sharia* risk and therefore, there is an urgent need to overhaul the modern Islamic financial products and institutions within the framework of true Islamic teachings, i.e., *Maqasid al-Sharia*.<sup>36</sup> For this purpose, some Islamic scholars have argued that the current research and scholarship should focus on the way that *Maqasid al-Sharia* (Objectives of *Sharia*) can be internalised by the Islamic institutions in their financial transactions.<sup>37</sup> Thus, realistically, the so-called *Sharia*-compliant instruments are not true Islamic alternative products. In addition to the conventionalisation concern, given the current focus of the contemporary Islamic

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<sup>36</sup> The Objectives of *Sharia* (*Maqaasid al-Sharia*) are categorised into those objectives that are essential, complementary, or desirable. In this thesis, whenever *Maqasid al-Sharia* is referred to they are only the essential objectives that are taken into account. Among the essential objectives, “protection of property” (*hifz al-maal*) is especially relevant to the research project here, although it is impossible to separate each of the objectives from the others. For more in this regard, see Caner K. Dagli ‘Islamic Law, Shariah-based Finance, and Economics’ (College of the Holy Cross: pre-publication draft) pp. 2-3.

<sup>37</sup> See Mohamad Akram Laldin *Fundamentals and Practices in Islamic Finance* (Kuala Lumpur: ISRA/INCEIF, 2008), pp. 71, 77.



banking and finance on two main prohibitions in Islamic finance namely *riba*<sup>38</sup> and *gharar*,<sup>39</sup> it is argued that modern Islamic banking and finance has been built up on two pillars: one pillar is translation, and the other pillar is prohibition. From another perspective, the banks and financial institutions that have in recent years been set up to do Islamic banking and finance are indeed organised along the lines of Anglo-

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<sup>38</sup> Riba, literally, means an excess or increase. In Islam, as per Quran (2:275) "God has forbidden riba." Similar condemnations against riba (usury-like concept) are also found in other religious texts from Buddhism, Judaism, Christianity, and Hinduism. Therefore, the prohibition on riba is not unique to Islam and it has been called by different names through history. It is interesting to compare riba with Hebrew *ribit* and other pre-Islamic prohibitions on "usury," e.g., usury in Code of Hammurabi (c. 1760 BC), usury in Hinduism and Buddhism (the earliest recording of usury in Hinduism goes back to the Vedic texts of Ancient India (2000-1400 BC) where the usurer (*kusidin*) is mentioned numerous times and interpreted as any lender with an interest. More references on interest charges are found in the later Sutra texts (700-100 BC), as well as the Buddhist Jatakas (600-400 BC). It was in this latter period of time that the first sentiments of contempt for usury are found. For more in this regard see Jain Lakshmi Chandra 'Indigenous Banking in India' (Macmillan and Co., limited, 1929, digitized 2010); and also consult <http://ibfn.wordpress.com/2009/04/24/money-matters-usury-in-hinduism-and-buddhism>. Note also the idea that is attributed to Plato "...capital may not exceed principal"; and also note Deuteronomy (23:19&20) "you shall not lend upon interest to your brother, interest on money, interest on victuals, interest on anything that is lent for interest. To a foreigner you may lend upon interest, but to your brother you shall not lend upon interest; that the LORD your God may bless you in all that you undertake in the land which you are entering to take possession of it".

The two basic types of riba in Islamic law are: a) riba in the Quran (called riba al-Jahiliyya / riba al-nasiya/riba al-qardi), and b) riba in Hadith (called riba al-fadl/riba al-mua'mali). The former relates to the present day money-loans and transactions on credit using money, while the latter relates to commodity-based transactions (exchanges). According to the latter, in order to avoid riba, any difference in quantity or quality in barter-exchanging of the same commodities/species is not allowed. However, in a banking and finance context, the major concern is the former riba i.e., dealing with money and credit transaction. As per a Hadith attributed to Prophet Muhammad "the worst and the most detrimental business is riba" (inna sharr al-makasib al-riba). See Al-Shaykh Muhammad bin al-Hasan al-Hurr al-Amili 'Wasaeel al-Shia' (Tehran: Al-Maktaba al-Islamiyyah, vol. 12/20, 6<sup>th</sup> edition, 1403 Lunar Hijri Calendar) p. 426, Hadith no. 23280.

<sup>39</sup> In Islamic law, the essence of risk is closely connected to the concept of gharar. Gharar is often an element of deception either through ignorance of the goods or services, the price, or through the incorrect description of the goods or services, in which one or both parties stand to be deceived through ignorance of an essential element of exchange. Gharar is divided into three types, namely gharar faahish (excessive), which vitiates the transaction, gharar yaasir (minor), which is tolerated and gharar mutawassit (moderate), which falls between the other two categories. Any given transaction can be classified as a forbidden activity because of gharar faahish (excessive) or disproportionate risk. See IOSCO 'Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products' (2008) p. 35.

American<sup>40</sup> financial practices rather than as organisations native to any Islamic tradition. Following the modern corporate governance rules, they run on the basis of these principles in exactly the same way as modern institutions: a) owners are separated from the professional management team (separation of ownership and control); b) equity holders are separated from the class of depositors/creditors; and c) a limited liability 'shield' is still operated.

In contrast to the *Sharia*-compliant approach, as per *Sharia*-based<sup>41</sup> approach, the product design or, on a larger scale, the design of a new viable alternative economic and financial system has to evolve from the translation or institutionalisation of the original sources of *Sharia*.<sup>42</sup> As per Taqi Usmani, in an Islamic setting, business transactions and institutions can never be disentangled from the underlying Islamic objectives and ethical purposes.<sup>43</sup> To be 'Islamic' it is not sufficient that the design of the transactions and institutions follow Islamic rules and principles, but it is also necessary that the objective and outlook of the business products and institutions reflect the identity of Islam which is distinguished from that of conventional business and finance.<sup>44</sup> However, a modern understanding of Islamic finance is very limited. It

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<sup>40</sup> As per *Dodge v. Ford Motor Company*, 204 Mich. 459, 170 N.W. 668. (Mich. 1919), a (modern) business corporation is organised and carries on basically for the profit of its stockholders/shareholders. The powers of the directors of the organisation have to be exercised to that end. The power of directors is to be employed in the choice of means to achieve that end, and does not extend to a change in the end itself, to the decrease of profits, or to the non-distribution of revenues among stockholders/shareholders in order to dedicate them to other purposes. At present, there are many contemporary Islamic business and financial institutions organised on the basis of this principle. From an Islamic perspective, it may be argued that, shareholder wealth maximisation is viewed as deficient.

<sup>41</sup> Major reasons for the appeal of "Sharia-based" financing are: a) to revive a sense of religious and cultural identity (identity politics); and b) to continue a tradition, to do business in the same way as pious predecessors.

<sup>42</sup> See Mohamad Akram Laldin 'Shari'ah Compliant vs Shari'ah Based Product' (ISRA Bulletin, vol.2, April 2009).

<sup>43</sup> The reason is largely that Islam governs all aspects of human life with a set of rules and principles.

<sup>44</sup> See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) pp.167-168.

has been concentrated on the prohibition of *riba* (interest) and has not taken into account many other fundamental concepts and rules of Islam which distinguish it from those of modern finance.

In contemporary Islamic banking and finance, the dominant approach is to model the economics of a conventional debt financing as any of the classical nominate contract forms in Islam by altering the substantive features of the Islamic nominate contracts. The philosophy and underlying rationale of Islamic banking seems to have been entirely overlooked because the instruments of *musharaka* (profit and loss sharing arrangements), the ideal instruments of financing and distributive justice according to *Sharia* have been ignored. The Islamic banks instead use the instruments of *murabaha* (cost plus mark-up sale) and *ijara* (leasing) within the context of the modern benchmarks like LIBOR etc., where the outcome of the product is not much different from the interest-bearing transactions.<sup>45</sup> Even *murabaha* and *ijara* are not implemented according to the rules required by *Sharia*. The basic concept of *murabaha* in Islam is that the financier should buy the commodity and then sell it to the client on the basis of deferred payment with a mark-up. From a *Sharia* point of view, it is essential that the relevant goods have come into the ownership and at least be in the constructive possession of the financier before it is transferred to the client. The financier will have to shoulder the risk of the goods during the period it remains under the ownership or possession of the financier. However, in practice, many Islamic

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<sup>45</sup> See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) pp. 165-167. Islamic banks and financial institutions have been forced to use *murabaha* and *ijara* techniques and their variants excessively in order to compete with conventional banks especially in providing an assured comparable rate of return for deposits. They have also been forced to use these pre-determined fixed return tools rather than contingent return instruments to avoid any potential mismatch of funds in both the liability and asset side of their balance sheets and also the liquidity shortage concerns.

banks and financial institutions do not follow this. For instance, as per Taqi Usmani<sup>46</sup>, some Islamic financial institutions have wrongfully thought that *murabaha* can be a substitute for interest, for all practical considerations. Therefore, they use *murabaha* arrangements even when the client needs capital for the expenses of running his operation, such as for payment of salaries or bills for the commodities and services that are already consumed or received. Clearly, *murabaha* cannot be used in this circumstance because no goods are being bought by the financier. In some circumstances, the client buys the goods on his own prior to any arrangement with the financial institution and then a *murabaha* is agreed on the basis of a buy-back scheme. This is again in contrast to *Sharia* because the buy-back scheme is unanimously ruled as illegitimate in *Sharia*.<sup>47</sup> In other circumstances the client himself is appointed as the agent of the financial institution to buy certain goods and to resell it to himself immediately after taking possession of the goods. This is not in conformity with the salient features of *murabaha* in *Sharia*. If the client himself is appointed as the agent to buy the goods, his capacity as an agent has to be distinguished from his capacity as a purchaser which means that after buying goods on behalf of the financial institution he must inform the financial institution that he has bought the goods on its behalf and then the goods should be transferred to him via the financial institution by way of a

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<sup>46</sup> See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) pp. 164-167.

<sup>47</sup> However, this understanding should be distinguished from *bay shart* (sale-with-a-repurchase-option), which is recognised in Shia school of thought and also incorporated in the Iran Civil Code articles 458-463.

proper offer and acceptance.<sup>48</sup> Until the second transaction occurs between the financial institution and the client, the ownership benefits and also the risk of the acquired goods by the client as the agent would belong to the financial institution. *Murabaha* is a type of *bay* (sale) contract and it is a firm rule of *Sharia* that the price in sale transactions has to be agreed at the time of transaction. The agreed price can neither be increased nor reduced without mutual agreement once it is determined by the parties to the contract. In practice, however, some financial institutions unilaterally increase the price of a *murabaha* contract in the case of delay in payment which is illegitimate according to *Sharia*. Some financial institutions roll-over the payment of the price of a *murabaha* contract in the case of default by the client. Clearly, this practice is not allowed by *Sharia* simply because once the goods are sold to the client it cannot once again be the subject matter of another sale to the same client. In *ijara*, as per Taqi Usmani<sup>49</sup>, in the same way as *murabaha*, some requirements of *Sharia* are usually overlooked. It is a precondition for a valid *ijara* transaction that the lessor shoulders the risks associated with the ownership of the leased property and that the usufruct of the leased property must be made available free of any burdens to the lessee for which he will have to pay a certain rent. However, in practice, some *Sharia* rules are violated in a number of *ijara* transactions. Even in the case of demolition of the leased property due to force majeure causes, the lessee is still obliged to keep paying the agreed rent which means that the lessor neither assumes the damages that

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<sup>48</sup> However, it seems this is not problematic from at least the viewpoint of the Islamic Shia school of thought. As per Iran Civil Code article 198 “[in a transaction] either or both parties may represent another. It is also possible that one person represents both parties to a transaction”. One person may even transact with himself as a party to a transaction and as an agent of the other party to the transaction. However, in these circumstances, the terms of the self-dealing contract should be reasonable. See also Iran Civil Code article 1072, and also Iran Commerce Code articles 358, 373 and 374.

<sup>49</sup> See Muhammad Taqi Usmani ‘An Introduction to Islamic Finance’ (Hague: Kluwer Law International, 2002) pp. 166-167.

occurred to his property nor delivers any usufruct to the lessee. This kind of *ijara* arrangement is contrary to the basic rules of *Sharia*.

Adjudications and court decisions in the West<sup>50</sup> especially in the UK and the US with regard to the re-characterisation<sup>51</sup> of some major so-called Islamic business and financial products namely *musharaka* (partnership), *murabaha* (cost-plus sale), *mudaraba* (venture capital), *istisna* (construction finance), *ijara* (leasing), and *sukuk* (bond-like certificates) confirms the dominance of the *Sharia*-compliant approach in contemporary Islamic banking and finance. Usually, the courts in the UK and US have re-characterised so-called *Sharia*-compliant transactions that are not native to true Islamic traditions and also substantive features in the Islamic nominate contracts but rather mere replications of conventional debt-based financing practices and thus have applied their own forum laws in order for the re-characterisation and translation of the so-called *Sharia*-compliant transactions into their own applicable financing techniques.

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<sup>50</sup> For an analysis of some cases concerning Islamic finance and business transactions adjudicated in the UK, the US, Malaysia and India see Zulkifli Hasan and Mehmet Asutay 'An Analysis of the Courts' Decisions on Islamic Finance Disputes' (ISRA International Journal of Islamic Finance, vol. 3, issue 2, 2011) pp. 41-71. Also for an analysis of the reaction of Western secular courts to Islamic business and financial contracts especially on the matters of conflicts of laws and recharacterisation concerns see Nicholas H. D. Foster 'Encounters between Legal Systems: Recent Cases Concerning Islamic Commercial Law in Secular Courts' (Amicus Curiae, November/December 2006) pp. 2-9.

<sup>51</sup> According to Dalhuisen, in secular jurisdictions, Islamic financial products encounter two special risks: the "recharacterisation of the proprietary interests" and the "clerical opinion". He believes that the Islamic financing cases will necessarily be recharacterised if they were brought in for adjudication before secular courts in the US and the UK - and they are most likely to be recharacterised or converted into secured lending transactions under Article 9 UCC by the US courts. He further argues that, in bankruptcies, the shareholders may not be able to use the shield of limited liability because it is arguably contrary to the principles of Islamic law. See Jan H. Dalhuisen 'Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law' (Hart Publishing, vol. 3, 4<sup>th</sup> edition, 2010) p. 168.

Some major examples of this are *Symphony Gems* case,<sup>52</sup> *Shamil Bank of Bahrain* case,<sup>53</sup> and the bankruptcy case *East Cameron*.<sup>54</sup>

A very interesting *Sharia*-based economic (including business and finance) doctrine, reflecting the inner dimensions of Islam is provided by the great Islamic scholar *Muhammad Baqir Sadr* in his well-known book *Iqtisaduna* ("Our Economy"). He attempts to introduce Islamic economic doctrine in the light of the laws and objectives of Islam. He argues for Islamic economics as a true alternative to Capitalism and Marxism and rejects any potential claim that Islamic economics is a combination

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<sup>52</sup> Islamic Investment Company of the Gulf "IICG" (Bahamas) Ltd. v. Symphony Gems N.V. & Others, High Court of Justice Queen's Bench Division Commercial Court [QBD (Comm Ct)] (13th February, 2002). It is said that this was the first time a Western court ruled on an Islamic banking and finance transaction. For a critical discussion on this case see Arshad A. Ahmed and U. F. Moghul 'Contractual Forms in Islamic Finance Law and Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Others: A First Impression of Islamic Finance' (Fordham International Law Journal, vol. 27, December 2003) pp. 150-194. It is interesting to compare this case with *Barclay Commerce Corp. v. Finkelstein*, 11 A.D.2d 327, 328 (N.Y. App. Div. 1960). There is a Rabbinic prohibition on charging two prices: lower cash price and higher credit price. Incremental credit cost would be *ribbis*. The alternative arrangement used was *heter iska* (investment contract), but the court ruled that *heter iska* was "merely in compliance in form with Hebraic Law". The court dismissed the religious characterisation of the arrangement and viewed it as a conventional interest-based debt instrument. A similar result is also found in *Arnav Industries, Inc. Employee Retirement Trust v. Westside Realty Associates*, 180 A.D.2d 463, 579 N.Y.S.2d 382 (1st Dept 1992).

<sup>53</sup> *Beximco Pharmaceuticals Ltd & Others v. Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 (28 January 2004). England and Wales Court of Appeal (Civil Division) decided on 28 January 2004 following an appeal from the judgment of Justice Morison dated 1 August 2003. The most important single issue in this case was the construction and effect of the form of the governing law clause contained in the financing agreements. That clause was as follows: "Subject to the principles of the Glorious *Sharia*'a, this Agreement shall be governed by and construed in accordance with the laws of England."

<sup>54</sup> This is one of the most eye-catching cases on how the *sukuk* (Islamic securities) may be treated in the US bankruptcy courts. On 16 October 2008, *East Cameron Partners* (a small oil and gas producer firm with producing lease holdings in the East Cameron 71 and 72 gas fields 20 miles offshore of Louisiana), which was the issuer of the first *sukuk* launched by a US-based company, filed for Chapter 11 bankruptcy in the US District Court for the Western District of Louisiana. The bankruptcy filing of *East Cameron Partners* renders a test for whether US courts recognise the securitisation of assets and also examines the claim that *sukuk* are basically different from interest-based debt. For detail see a report by Blake Goud 'East Cameron Sukuk Sinks' (Islamic Business & Finance's US correspondent, Islamic Capital Markets) Available via the Internet at [www.cpifinancial.net](http://www.cpifinancial.net)

of Capitalism and Marxism.<sup>55</sup> He believes that Islam possesses an economic order in its own right. According to him, Islamic economic doctrine is based on three principles: multi-ownership right, limited liberal economy<sup>56</sup>, and social justice.<sup>57</sup> Regarding the issue of ownership, Islam, at the same time and equally, recognises three different types of ownership: private, public, and state.<sup>58</sup> With regard to the limited liberal economy, there are two restrictions that limit the self-interested economic activities of individuals. One is an internal force or recommended rules i.e., moral values that guide a person on how to act in economic life, e.g., engaging in socially beneficial businesses rather than merely pursuing his self-interested purposes. The other is normative rules that are dictated by *Sharia* which expressly prohibit economic activities such as hoarding and exploitation of labour and also recognises the intervention and supervision of the state<sup>59</sup> in the market for the protection of public interests and social rights. Concerning social justice<sup>60</sup>, he believes that it is comprised of two concepts:

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<sup>55</sup> See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 43-50, 331-355. This book is written between 1960 and 1961.

<sup>56</sup> For more detail on the concept and scope of freedom and liberty (hurriyyah) in Islam especially in an economic and business context see Quran (4:59); Saduq Abi Ja'far Muhammad bin Ali bin al-Hussein bin Musa' bin Babawayh 'Ilal al-Sharaye' (Al-Maktabat al-Haydariyyah, vol. 1/1, 1385 Lunar Hijri Calendar) p.253; Muhammad Hussein al-Tabatabaee 'Al-Mizan Fi Tafsir al-Quran' (Beirut: Mu'assasa al-Alami li al-Matbu'at, vol. 1/20, 1390 Lunar Hijri Calendar) p.253; Abi Muhammad al-Hasan bin Ali bin al-Hussein bin Sho'bat al-Harrani 'Tuhaf al-Uqul' (Daar al-Kutub al-Islamiyyah, 1384 Lunar Hijri Calendar) p.347.

<sup>57</sup> See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 281-292.

<sup>58</sup> In Islam, according to Sadr, the ownership right or the ability to benefit from wealth distribution is basically linked to two factors: labour and need. See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 281-292.

<sup>59</sup> With regard to the legitimacy and also necessity of the intervention of the state in economies see Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 685-692.

<sup>60</sup> In Islamic scholarship, social justice has not been defined clearly. For a detail discussion on the origin and also the implications of justice in Islam see Alaa'eddin Ali al-Muttaqi bin Hisam al-Din al-Hindi 'Kanz al-Ummal Fi Sunnan al-Aqwaal wa al-A'maal' (Birut: Mu'assasa al-Risaalah, vol. 6/16, 1399 Lunar Hijri Calendar) p.367, Hadith no. 16101; Muhammad Hussein al-Tabatabaee 'Al-Mizan fi Tafsir al-Quran' (Birut: Mu'assasa al-Alami li al-Matbu'at, vol. 4/20, 1390 Lunar Hijri Calendar) p.116; Abi Muhammad al-Hasan bin Ali bin al-Hussein bin Sho'bat al-Harrani 'Tuhaf al-Uqul' (Daar al-Kutub al-Islamiyyah, 1384 Lunar Hijri Calendar) pp.204, 282.



public joint-and-several responsibility<sup>61</sup> and social balance.<sup>62</sup> From a methodological perspective, according to Sadr, Islamic economics is not science but rather a new approach that only gives general clues and guidance on how to act in economic life and how to run the economy.<sup>63</sup> He believes that the essence and philosophy of the Islamic economic order is based on justice, which in turn has to be implemented and also evaluated on the basis of two factors: ethical/moral values, rather than specific scientific rules and present realities – mainly economic ones.<sup>64</sup> Surprisingly, he states that the starting point as well as the primary source of the Islamic economic order is *Sharia*, that is to say Islamic economics has to be extracted from the sources of *Sharia*. That is why, as per Sadr, Islamic economics has not been created or invented at some point in the past but rather has been discovered from *Sharia* i.e., from those rules of *Sharia* that relate to economic life and were originally found in the *Quran* and *Sunnah*. Therefore, an Islamic economist, unlike a secular economist, is not free to do whatever he sees fit. According to Sadr, the Islamic economist and this also applies to the Islamic state as well, is limited to following the general framework of Islamic economic objectives, policies, and rules that are discoverable from *Sharia*.<sup>65</sup>

Another interesting systemic idea that has in recent decades emerged in the world of Islamic economics is an approach based on Islamic moral economy. This systemic approach, whose emergence in the modern sense goes back to the 1960s, was suggested as a solution to the failure of economic development as well as the rise of Islamic political identity in the Muslim world. The major scholars who have

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<sup>61</sup> See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 661-669.

<sup>62</sup> See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 671-683.

<sup>63</sup> See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 315-319, 359-365, and 369. As per Sadr, Islamic economics is only a part of the whole code covering all aspects of the life that a Muslim should follow in his lifetime in order to achieve the ultimate objective. See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 293-391.

<sup>64</sup> See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 290-292.

<sup>65</sup> See Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab Press, 2003) pp. 369-407.

developed the Islamic moral economy idea are: Chapra,<sup>66</sup> Ahmad,<sup>67</sup> Naqvi,<sup>68</sup> Siddiqi,<sup>69</sup> - of the more recent scholars who are advocating the development of this thinking is Asutay.<sup>70</sup> The fundamental concepts of *tawhid* (unity of God), *adalah* (justice), *haq* (right), *ihsan* (beneficence), *rububiyyah* (staying on the path to perfection), and *tazkiyah* (spiritual purification) provide the axiomatic foundation of this Islamic moral economy approach. All these concepts are in turn considered to be included under the general framework of Objectives of *Sharia* (*Maqasid al-Sharia*). The assumption of a morally-oriented human being- homoIslamicus- is at the heart of its methodological foundation.<sup>71</sup> When it comes to applying the fundamental principles of the Islamic moral economy to Islamic banks and financial institutions, it goes much further than

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<sup>66</sup> See M. U. Chapra 'Islam and the Economic Challenge' (Leicester: The Islamic Foundation, 1992); and also M. U. Chapra 'The Future of Economics: An Islamic Perspective' (Leicester: The Islamic Foundation, 2000).

<sup>67</sup> See K. Ahmad 'Economic Development in an Islamic Framework (in K. Ahmad and Z. I. Ansari eds., Islamic Perspectives: Studies in Honour of Mawlana Sayyid Abul A'la Mawdudi)' (Leicester and Jeddah: Islamic Foundation and Saudi Publishing House, 1979) pp. 223-240; K. Ahmad 'Islamic Approach to Development: Some Policy Implications' (Islamabad: Institute of Policy Studies, 1994); K. Ahmad 'The Challenge of Global Capitalism (in J. H. Dunning ed., Making Globalization Good: The Moral Challenges of Global Capitalism)' (Oxford: Oxford University Press, 2003) pp. 181-209.

<sup>68</sup> See S. N. H. Naqvi 'Ethics and Economics: An Islamic Synthesis' (Leicester: Islamic Foundation, 1981); S. N. H. Naqvi 'Islam, Economics, and Society' (London: Kegan Paul International, 1994); and also S. N. H. Naqvi 'Perspectives on Morality and Human Well-Being: A Contribution to Islamic Economics' 2003

<sup>69</sup> See M. N. Siddiqi 'Muslim Economic Thinking: A Survey of Contemporary Literature' (Leicester: The Islamic Foundation, 1981).

<sup>70</sup> See Mehmet Asutay 'Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs. the Realities of Islamic Finance' (Asian and African Area Studies vol. 11, issue 2, 2012) pp. 93-113; Mehmet Asutay 'A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System' (Kyoto Journal of Islamic Area Studies, vol. 1, issue 2, 2007) pp. 3-18; and also Mehmet Asutay 'Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of HomoIslamicus by Homoeconomicus' (IIUM Journal of Economics and Management, vol. 15, issue 2, 2007) pp. 167-195.

<sup>71</sup> This very challenging premise is similar to what is assumed of a human being in a Capitalist economy i.e., a "rational" human being. The same criticisms levelled against the rationality of human beings may similarly be applicable to the moral-orientation of individuals. On this basis, the conclusions derived on the basis of these premises may be very challenging particularly due to the reality of greed and pursuit of self-interest in the nature of human beings.

the mere prohibition of *riba* and a holistic approach to financing society as a whole is assumed.<sup>72</sup>

On a very small scale, for the purposes of overhauling contemporary Islamic banking operations, some Islamic scholars<sup>73</sup> have suggested the following major changes in this regard. Firstly, that there should be no interest on the deposits of the fund-providers;<sup>74</sup> but, their capital has to be guaranteed. Secondly, that lending and investing have to be distinguished. Bank loans have to be interest-free but with a service charge, while investments have to be on the basis of profit and loss sharing (*mudaraba*) schemes. Commercial banks will be able to advance funds but they will not be allowed to involve in investment-financing schemes. However, the proposed overhaul allows commercial banks to engage in investment-financing through investment banks and investment companies under specific circumstances where it would be socially desirable and commercially viable to engage in such investment-financing. Finally, that the value of capital lost due to inflation has to be compensated. As per the above approach, commercial banks should act as mere service providers instead of money-lenders or investment-partners. According to Abdul Gafoor, depositors are deemed as lenders to the bank with no interest but they are assured that their funds/deposits will be repaid fully.<sup>75</sup> Some scholars believe that Islamic

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<sup>72</sup> See Mehmet Asutay 'Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs. the Realities of Islamic Finance' (Asian and African Area Studies, vol. 11, issue 2, 2012) p. 99; Mehmet Asutay 'Islamic Banking and Finance and its Role in the GCC and the EU Relationship: Principles, Developments and the Bridge Role of Islamic Finance' (in C. Koch and L. Stenberg eds., The EU and the GCC: Challenges and Prospects) (Dubai: Gulf Research Centre, 2010) pp. 35-58; Mehmet Asutay 'Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of Homoislamicus by Homoeconomicus' (IIUM Journal of Economics and Management, vol. 15, issue 2, 2007) pp. 167-195.

<sup>73</sup> A. L. M. Abdul Gafoor 'Islamic Banking & Finance: Another Approach' (Kuala Lumpur: A.S. Noordeen, 2000) pp. 3-4.

<sup>74</sup> In Islam, one may earn in the form of wages, profits, awards, and rents but not interest (*riba*).

<sup>75</sup> See A. L. M. Abdul Gafoor 'Islamic Banking & Finance: Another Approach' (Kuala Lumpur: A.S. Noordeen, 2000) pp. 6-7.

finance and banking favours 'changing the inherently asymmetrical contractual relationship between borrowers and lenders to reduce inequity' between the providers and recipients of funds in relation to risks and rewards structure. They argue that a *riba*-based financial system, which has been at the centre of the recent financial crisis, burdens disproportionate risks of repayment on the borrower, who must repay the principal of loan and also its compounded interest, whether the investment or business for which the funds were channelled made a profit or loss.<sup>76</sup>

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<sup>76</sup> See Ehsan Habib Feroz 'Wrongs to Rights' (Islamic Horizons, March/April 2009), pp. 22-24. Available via the Internet at <http://papers.ssrn.com/abstract=1409140>. Also, see Ehsan Habib Feroz and Blake Goud 'Grameen La Riba Model: A Strategy for Global Poverty Alleviation' (Journal of Islamic Economics, Banking and Finance, vol. 5, issue 2) p. 2.

## **1.5 The Research Methodology**

This thesis employs a foundational and qualitative research methodology and does not concern itself with any quantitative data analysis. An interaction of both deductive and inductive reasoning methods was used in the library-based research. A deductive method was mainly used in researching the foundational theory and an inductive process in the part devoted to building up the new alternative economic, business and financial model. To prove the elements of the theory as well as the model, religious supporting authorities along with intellectual reasons are provided.

In the history of the development of economic theories, it is widely argued whether it is the economic changes and developments that force the creation of new economic theories (a bottom-up process) or the abstract economic theories that

create or affect the trend of economic developments (a top-down process).<sup>77</sup> In other words, one approach is that policymakers should determine the policies and priorities that they see are proper and on the basis of which enact laws and issue rules and regulations (a deductive approach) to run the economic and financial system. The other attitude is that they are the economic realities and changes that force the policymakers to set the policies and priorities and implement them in society and

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<sup>77</sup> For a sample of detail discussion in this regard see Harry Elmer Barnes 'Economic Science and Dynamic History' (Journal of Social Forces, Vol. 3, Issue 1, November 1924) pp. 37-56. According to Barnes at p. 40, some economic thinkers, who had inspired by the thoughts of Newton, who had proved that certain basic laws, especially the law of universal gravitation, control the movement of the heavenly bodies, deduced the premise that this natural order and natural law must operate to govern social and economic issues as well, and that it considered to be an affront to God to interfere by legislation in the regulation of economic processes. Also as per Barnes at p. 41, beginning with Ricardo, his followers turned their attention primarily to the problems of value and distribution and the method of this school was entirely deductive, and many members of the school were disdainful of the quantitative measurement of economic issues, "Ricardo once contending that if the facts of contemporary economic life did not square with his well thought out theory it was so much the worse for the facts". In contrast, as per Barnes at p. 43, Schmoller, in his famous *Grundriss der Allgemeinen Volkswirtschaftslehre* "makes elaborate use of biological, ethnographic, statistical and psychological material, all woven together and interpreted from the genetic standpoint. Absolutism in theory is largely abandoned, the metaphysical and logical deductive method eschewed, and great emphasis is laid on the facts and processes of economic evolution in relation to all the major departments of economic life and activity". Having learned of these thoughts, as per Barnes at p. 43, beginning with Heeren in the late 18th century and taking then a solid form with Sismondi and Richard Jones, some economic thinkers concluded the fact that that sound economic theory must be laid on the recognition of the interaction between economic institutions and processes and the rules and principles to be extracted from a study thereof, and to recognize that the wide differences in types of economic life in the past calls for a tentative and comparative approach to the problem of economic generalizations. According to Barnes, far the most synthetic, complete and dynamic trend in economic theory has been that expansion of the historical approach now well-known as institutional economics. This way of studying economic phenomena focuses primarily on a complete understanding of the sociological context of economic processes. "The interrelation of economic and other social institutions and activities must be completely understood". Finally, as per Barnes at pp. 47-48, that is why the dogma of unchangeable "economic laws" applying to all peoples with different cultures and sociological background has to be much criticised. Economic laws have to be formulated only on the basis of many repeated phenomena under the similar conditions. And also another problem in the method of formulating economic laws lies in the fact that the economic evolution of humanity is not yet a completed process. Therefore, even if we could find out enough similarities and repetitions in the economic life of the past, we would not be warranted in articulating fixed and inviolable universal laws, for we could not be sure that the developments of the future would not prove falseness of all generalizations based on the past.

economy (an inductive approach). Comparing this to legal systems, the former approach is much more similar to civil law and the latter fits better with common law systems. The adopted approach in the research is a kind of interaction of both methods: a set of general objectives, policies and rules (following the former approach) in parallel to best customary practices<sup>78</sup> (following the latter approach) are integrated to provide a proper economic, business, and financial model. Sometimes, religious beliefs, ideals or fundamental values of humanity set the policies and priorities to run the economy and in some circumstances it is the realities, customs and practices that dictate the policies and priorities of the economy.

The methodology of the research is also inspired by the similar method that was used at the beginning of the Islamic religion more than fourteen centuries ago. Islam introduced a new worldview and objectives while recognising the teachings of the previous religions<sup>79</sup> namely Christianity and Judaism and also adopting customs and

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<sup>78</sup> For more details on the nature, definition and validity of proper customs or best practices as an autonomous legal source especially in the context of transnational private law see Jan H Dalhuisen 'Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law' (Hart Publishing, vol. 1, 4<sup>th</sup> edition, 2010) pp. 155-163; and also from the same author see 'Custom and its Revival in Transnational Private Law' (Duke Journal of Comparative and International Law, vol. 18, issue 339, 2008). As per Dalhuisen, three different types of custom (best practice) should be distinguished: a) a custom that operates as an autonomous source of law b) a custom whose validity and enforcement comes from codifications or statutes; c) a custom (or practice) whose operation depends on the intent of parties to a contract. He (in fn. 327) further points out that not all customs and practices have the same legal nature. According to him, some customs and practices have no legal effect such as behavioural patterns, routines and habits, and some customs may acquire legal significance but can be rendered unenforceable by informing the other party to a given contract.

<sup>79</sup> It should be noted that the religion of Islam, as per the Quran, is considered the last and complete version of the Christianity and Judaism. Islam expressly recognises these religions but claims for its own finality and completeness. See the Quran (3:84) and (33:40).

best practices of the time with only some marginal changes.<sup>80</sup> Similarly, the idea of Balancism is introduced as a new alternative thinking on the basis of fundamental values, rules, norms, and principles and also the contemporary best practices, which are in conformity to the implications of the foundational theory of Balancism i.e., “Rights and Duties Balance (RDB)” especially its variant in an economic context which is called “Benefits and Burdens Balance” theory.

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<sup>80</sup> The Islamic rules that were indeed originally best practices of the time and later confirmed by Islam are called *ahkam imdaee*. For more in this regard see Mahmoud bin Jafar ‘Qawame’ al-Fudul’ (chap-e sangi, p. 198); Abi Ishaq Ibrahim Gharnati a.k.a. Shaatibi (tashih-e Muhammad Muhyi al-Din Abd al-Hamid) ‘Muwafiqat’ (Egypt, vol. 2) p. 54; Baqir Bihbahani ‘Al-Fawaeed al-Atiq’ (Damime-ye Fusul) p. 3; Muhammad Jafar Jafari Langroodi ‘Huquq Madani: Sulh wa Rahn’ (Ibn Sina, vol. 1, 1<sup>st</sup> edition) pp. 201-202; Muhammad Jafar Jafari Langroodi ‘Huquq Madani: Wasiyyat’ (Ibn Sina, vol. 2, 1<sup>st</sup> edition) p.26.



## **1.6 The First Tier of the Model (1): The Ultimate Aim (Social Justice/Social Balance)**

The ultimate goal of the model/system (i.e., “social justice”) is deduced from the highly respected values of human societies as well as some fundamental principles of Islam found in the *Quran* and *Sunnah*. As per the Quran (2:143) “thus, We (i.e., the Creator/God) have made of you an *Ummah* (i.e., a unified society) justly balanced, that you might be witnesses over the (other) nations, and the Messenger (i.e., the Prophet Muhammad) a witness over you”<sup>81</sup>

Social justice, in general, requires justice in many aspects of a society including (but not limited to) politics, the economy, education, and financial realms. Among all these social aspects, this research is concerned only with economic, business and financial spheres. For example, if one was to think what was meant by justice in politics, one would say it means balance between power and the accountability of the people in charge of running the country. If there was no proper balance between these two, then the conclusion is that the political system is unjust (because it is imbalanced).

As illustrated before, justice, by definition, has two dimensions: right (positive aspect) and duty (negative aspect). Regarding the positive aspect, it means giving a person what he deserves. In terms of the negative aspect, it means preventing a person from harming the right of others and, if any harm is done, forcing him to

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<sup>81</sup> For more supporting authorities in this regard see the Quran (57:25), (7:29), (3:18), (4:3), (55:9), (5:8&42), (2:282). The term al-Mizan is mentioned several times in the Quran in verses urging human beings for fairness in dealings among themselves (6:152, 7:85, 11:85) and as a metaphor for the Creator/God standard of right and wrong revealed by the prophets: “we sent down with Our Messengers [Prophets] the Book and the Balance so that people might behave equitably and uphold justice” (see 57:25 and also 42:17, 55:7-9). Given the Aristotelian influence on Islamic philosophy, it is not surprising that the concept of social justice may have strong Aristotelian undercurrents, but this is not further explored.

compensate or honour his obligation towards others whose rights are affected. To achieve social justice, there has to be a balance between the “rights” and “duties” of any human being. In other words, there must be a balance between what he deserves to have and also to receive from others in the society (including the society as a whole) and the obligations that he has to discharge towards the others in the society (including the society as a whole). It thus becomes clear that an integral part of social justice is “social responsibility”<sup>82</sup>. Any economic activity (e.g., the allocation of resources, using capital and doing trade and investment activities to generate profit) should not only be for self interested reasons but also for the benefit of society at large. In other words, in any individual activity there has to be some balance between self interest and social interest. It is not legitimate to make profits at the expense of society. That is why a proper economic system should have a socially responsible trading and investing mechanism. Social responsibility further requires that no one should take advantage of someone else’s distress and problems and should not exploit him when suffering hardship. All human beings should in fact help each other and perform kindnesses for each other.

Following the general understanding of the scales of justice, I would argue that justice is achieved when the two sides (one side i.e., the positive side is considered as “rights” and the other side i.e., negative side as “duties”) of the scales are in a balanced position. Some Islamic scholars have however understood the concept of justice in a different way. They have focused more on equality in this regard.<sup>83</sup> Some scholars have referred to vertical justice (i.e., equality) between God and human

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<sup>82</sup> Al-daman al-ijtimaaee

<sup>83</sup> See for example A. Smirnov ‘Understanding Justice in an Islamic Context: Some Points of Contrast with Western Theories’ (Philosophy East and West, vol. 46, no. 3, 1996) p. 337. The focus on equality is made by referring to Quran (49:13); Sahih Al-Bukhari (1623, 1626, 6361); Sahih Muslim (98); and Sunan Al-Tirmidhi (1628, 2046, 2085).

beings and horizontal justice among human beings themselves.<sup>84</sup> Equality is obviously equal to justice in some cases but it is not in all circumstances. I would argue that the true meaning of justice is “balance” rather than equality or any other similar concept. In some cases equality brings about injustice. Intellectually, the basic argument is that human beings are created with unequal needs and granting them an equal share of the proceeds of natural wealth is in itself unjust. They have to be granted in proportion to their reasonable and legitimate needs, which are not absolutely equal for all human beings. In addition to some other possible intellectual arguments, interestingly, there are some religious authorities that reject the consideration of equality as equivalent to justice.<sup>85</sup>

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<sup>84</sup> The relevant Quranic verses that often cited in this regard are Quran (4:135) “... be upholders of justice, and bearers of witness to truth for the sake of Allah/God, even though it may either be against yourselves or against your parents and kinsmen, or the rich or the poor: for Allah is more concerned with their well-being than you are. Do not, then, follow your own desires lest you keep away from justice...” According to this verse, equal treatment is considered to be an important part of justice. It may be argued that this concept can be used with regard to regulating business relationships and relationships among market participants. See also Quran (16:90) “Surely Allah enjoins justice, kindness and the doing of good to kith and kin, and forbids all that is shameful, evil and oppressive”.

<sup>85</sup> For example see the Quran (39:9) “are those who know equal to those who do not know?” It is well understood from this verse of the Quran that the people who try and do their best for the benefit of society and who are obedient and fearful of the Hereafter are not equal to those who do not do such acts.

## 1.7 The First Tier of the Model (2): The Foundational Theory (Rights-and-Duties<sup>86</sup> Balance/Benefits-and-Burdens Balance “Balancism”)

The foundational theory of the model is inspired and deducted by the following intellectual reasons, human values, policies, and religious authorities.

First, nobody can be burdened with a duty save to one’s capacity.<sup>87</sup> The following are the logical consequences of this statement: a) duty (*taklif*) follows right (*haq*): in other words, duty comes after the granting or acquisition of the right. Therefore, the originality of this is with the concept of right and not with duty; b) there has to be a balance between the rights and duties of a person; c) the maximum duty which can be imposed on a person will not go beyond his rights and abilities.

Second, everybody has to enjoy the fruit of the good that one has acquired and suffer for the wrong that one has committed.<sup>88</sup> The necessary effects of this are: a) whoever does an atom's weight of good shall enjoy it; and whoever does an atom's weight of wrong shall behold it<sup>89</sup>; b) no one shall avail anyone anything.<sup>90</sup>

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<sup>86</sup> Note that right (*haq*) and duty (*taklif*) have different manifestations. Ownership, return (including profit which is generated as a result of the property/maal conversion e.g., as a result of investing capital in investment activity, or rent i.e., the yield of property/maal itself such as through the lease of car), and wages (i.e., remuneration in return for the provision of labour services) are all dealt with within the concept of right/*haq*. Liability, in its different manifestations e.g., accountability, loss and damages, is dealt with within the concept of duty/*taklif*.

<sup>87</sup> *Laa yukallif Allahu nafsan illa wus’aha*. See the Quran (2:233&286), (6:152), (7:42), (23:62), (65:7). In terms of economic and financial capacity, the Quran (65:7) “Allah (God) does not burden any human being beyond the means that He has bestowed upon him” is implicitly concerned with the duty limit of a person pertaining to primary wealth. The Quran (2:233&286), (6:152), (7:42), and (23:62) implies the duty limit of a person pertaining to his total capacity/ability (both the primary and secondary wealth acquisitions). What is meant by primary/natural wealth is the wealth created by God with no contribution from human beings. Secondary/subordinate wealth means any wealth acquired as a result of the contribution of human beings.

<sup>88</sup> *Laha maa kasabat wa alaiha maa iktasabat*. See the Quran (2:286). See also the Quran (6:164) “everyone shall bear the consequence of what he does and no one shall bear the burden of another”

<sup>89</sup> See the Quran (99: 7&8).

<sup>90</sup> *Laa tajzi nafsun an nafsini shay’aa ...*See the Quran (2:48).

Third, nobody can own something unless it is acquired as a result of one's (effort) contribution.<sup>91</sup> This statement has several important implications. Firstly, unless the one's share from the proceeds of primary wealth and also the owner of a property disposes his ownership right voluntarily for the benefit of someone else, contribution (*sa'y*) is the only cause and valid source of ownership acquisition including (but not limited to) right, profit and enjoyment. However, it should be noted that natural wealth resources, which have been created by God with no participation by human being have to be distributed equitably among all human beings according to their reasonable needs. Natural wealth resources are hereafter referred to as primary/natural wealth and the wealth created as a result of the contributions of human being is hereafter referred to as secondary/subordinate wealth, which is acquired or distributed according to the amount of contribution made by any human being. The second implication is that distribution or one's acquisition of benefit is determined based on the amount of one's contribution.<sup>92</sup> A further implication is that *sa'y* (contribution) is a generic term and it includes any tangible and intangible contribution made for the acquisition of valuable things e.g., acquisition of ownership right.

Fourth, it is further can be stated that anybody who benefits from a business shall bear all associated costs and losses with that business.<sup>93</sup> The major implication of this is that loss follows profit, and also that nobody should bear the burden of another.<sup>94</sup>

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<sup>91</sup> *Laysa lil insan illa maa sa'a*. See the Quran (53:39-41), (76:22), (21:94), (17:19), (88:9), (18:103-105). See also the Constitution of Iran article 46 "everyone is the owner of the fruits of his legitimate business and labour ...".

<sup>92</sup> See the Quran (3:30).

<sup>93</sup> See al-Majallah al-Ahkaam al-Adliyyah articles 85 and 87. It is also recorded as *al-ghunm bi al-ghurm* or *al-kharaj bi al-daman* ("benefit through burden" or "benefit corresponds burden" or "entitlement to benefit follows corresponding assumption of burden").

<sup>94</sup> See the Quran (53:38).

Fifth, finally, regarding the notion that harming the rights of others (including the abusive exercise of one's own legitimate right) is not allowed, and if any losses and damages incurred by the victim as a result of the harmful action they shall have to be cured and remedied entirely,<sup>95</sup> clearly shows that one may exercise one's rights without harming the rights of others. If any harm is created- even as a result of the exercise of one's rights, the injured party is entitled to full compensation.<sup>96</sup> One's property has to be protected like one's blood.<sup>97</sup>

Considering the above fundamental concepts, the concept of justice is understood as follows. Justice is recognised at two different levels; at the individual level and at the social level.<sup>98</sup> Justice in an individual context is there to ensure one's right to entitlements whether it is rights over primary wealth or a secondary right earned as a result of a contribution and also, not to harm or take away one's legitimate right without one's valid consent. At the social level, Islamic thinkers have not provided

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<sup>95</sup> See Muhammad bin al-Hasan al-Hurr al-A'mili 'Wasaeel al-Shia' (Tehran: Al-Maktabat Al-Islamiyyah, vol. 17/20, 6<sup>th</sup> edition, 1403 Lunar Hijri Calendar) p.333, Hadith no. 32241; Hasan Bojnourdi 'Al-Qawaeed al-Fiqhiyyah' (Qom, vol. 6, 1384 Solar Hijri Calendar) pp. 9, 12, 78; the Constitution of Iran article 40, section 5 of article 43, and part 2 of article 46; Murtaza Mutahhari 'Barrasiye Ijmaaliye Mabaniye Iqtisade Islami' (Tehran: Hikmat, 1403 Lunar Hijri Calendar) pp.175-177; and also Muhammad Taqi Ja'afari 'Manaabe Fiqh (a.k.a. Rasaaeel Fiqhi)' (Tehran: Mu'assasa Nashr Karamat, 1<sup>st</sup> edition, 1377 Solar Hijri Calendar) pp. 132 and 134.

<sup>96</sup> See Hasan Bojnourdi 'Al-Qawaeed al-Fiqhiyyah' (Qom, vol. 2, 1384 Solar Hijri Calendar) pp. 17-39. See also Iran Civil Code article 238.

<sup>97</sup> This saying is attributed to the Prophet Muhammad. Also, see the Constitution of Iran articles 46 and 47.

<sup>98</sup> According to Pipkin, justice is in its nature social, because it exists in the right relation of individuals one to another. But when the term "Social Justice" is used it is meant the collective expression that is given to the idea of justice by the laws and practices, the orders and the social provisions which represent the will of the community. As per Pipkin, to answer to what is meant by Social Justice, we must first try to find a complete idea of the community/state, looking at the multiply relations within it, each of which contributes to the aggregate of Social Justice. Pipkin writes, while the development of the idea of Social Justice is examined in this or that community/state, it must be understood that it is only by an international order that the full conception of Social Justice can be achieved". See Charles W. Pipkin 'The Idea of Social Justice: A Study of Legislation and Administration and the Labour Movement in England and France between 1900 and 1926 (1927)' (available at HeinOnline) pp. ix and x of the introduction.

a clear definition of social justice, however it is often understood as either social equality (*musaawat*<sup>99</sup>), social equity (*insaaf*<sup>100</sup>), social balance (*tawaazun*<sup>101</sup>), equal access to opportunities<sup>102</sup>, social/public interests (*al-masaalih al-ijtimaiyyah/a'mmah*<sup>103</sup>), or government interests (*al-masaalih al-hukumiyyah*<sup>104</sup>). Mutahhari,<sup>105</sup> a leading Islamic scholar, believes that social justice is in fact a flexible concept, that is to say at the social level the rights of some people will unavoidably always be harmed. A just rule is one which is most beneficial and least harmful. As can be seen from this definition, social justice equals social interests.

In western terminology, according to Stammler, the word justice has two meanings. One meaning is that justice is to follow and carry out whatever the law determines. The other meaning of justice denotes “the ultimate aim of law”. As per this meaning, all legal volition has to serve a single fundamental idea and hence any legal volition has to be judged by this standard. As per Stammler, different ideas have been provided regarding the the second meaning i.e., the ultimate aim of law and

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<sup>99</sup>It seems this understanding is made by reference to the rights of people in primary wealth. However, I would argue for equitable distribution of primary wealth rather than its equal distribution (though, an equitable distribution may in some cases happen in the form of equal distribution). Equitable distribution means distribution according to the “reasonable needs” of a human being. The type and amount of reasonable needs of human beings may differ from one to another.

<sup>100</sup> It is true to say that this understanding is made by reference to the rights/share of people in primary wealth. People will enjoy the primary wealth on the basis of their “reasonable needs”.

<sup>101</sup> It is true to say that this understanding is a more comprehensive understanding of justice whether it is applied at the individual level or social level and whether it refers to the rights of people in primary wealth resources or in secondary wealth. This understanding of justice can also to some extent be found in the writing of Muhammad Baqir Sadr, a leading (late) Islamic scholar, in his well-known book “Iqtisaduna” where he refers to social balance (*al-tawazun al-ijtimaiyyah*) and social responsibility (*al-daman al-ijtimaaeeiyah*) as the ultimate objective of Islamic economics. See Muhammad Baqir Sadr ‘Iqtisaduna’ (Qom: Bustan-e Ketab Press, 2003).

<sup>102</sup> For example see the Constitution of Iran article 3 section 9. This definition of justice is widely accepted in western world.

<sup>103</sup> It is true to say that this understanding is a society-favoured definition of justice. It allows for the harming of the rights of individuals if the interests of society require it to do so.

<sup>104</sup> It seems this definition can only be justifiable in a dictatorship country.

<sup>105</sup> See Murtaza Mutahhari ‘Barrasiye Ijmaaliye Mabaniye Iqtisade Islami’ (Tehran: Hikmat, 1403 Lunar Hijri Calendar) pp. 14-16 and 27.

among all these the “pleasure” doctrine is widely accepted. According to this theory “the highest law of human volition is the attainment of personal pleasure and the avoidance of pain”.<sup>106</sup>

The applied definition of social justice in this research project is social balance (*tawaazun*) and social interest (*masaalih*) is considered just one important factor when it comes to the balancing test in order to determine whether a given right can be exercised or it has to be prevented from exercising. What is meant by balance is a balance between rights/benefits and duties/burdens.<sup>107</sup>

As stated above, one’s rights are either granted through one’s equitable share in primary wealth or earned as a result of one’s contribution in creating secondary

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<sup>106</sup> See Rudolf Stammler (Translated from the German by Isaac Husik, University of Pennsylvania) ‘Idea of Justice’ (University of Pennsylvania Law Review and American Law Register, Vol. 71, Issue 4) pp. 303-311.

<sup>107</sup> The universe is in balance. When an event occurs in the universe, something else occurs to balance it out. So, everything in the universe should be balanced including rights and duties and also benefits and burdens. If there is a right, there should be a duty to balance it out. If there is a benefit, there should be a burden to balance it out. Everybody will have to shoulder the negative side of his rights or benefits, that is to say duties or burdens respectively. Otherwise, justice fails. Scales are considered to be the symbol of balance i.e., justice. One side carries negative aspects i.e., duties or burdens or the similar weights and the other side carries positive aspects i.e., rights or benefits or the similar values.



wealth.<sup>108</sup> The distribution of primary wealth is not problematic. To be just, it has to be distributed according to the type and amount of reasonable needs of people. It is the latter category i.e., secondary wealth where distribution is such a major concern. To be just, it has to belong to one as a result of one's contribution in creating it.

Contributions may be made either in the form of intangible (software) or tangible (hardware).<sup>109</sup> Major intangible contributions are labour, expertise,

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<sup>108</sup> In western terminology, according to Stanford Encyclopedia of Philosophy, what is allowed to people to do or owed to people, as per some legal system, social covenant, or ethical theory is a "right". In other words, "right" is either a permission to do something, or an entitlement to be done unto e.g., "right to welfare", or a permission not to do something, or an entitlement to be left alone (i.e., "non-interference") e.g., "right to not to vote". See Stanford University 'Stanford Encyclopedia of Philosophy' (First published Mon Dec 19, 2005; substantive revision Sat Jul 2, 2011) Retrieved Mon March 11, 2013. However, it should be noted that, there is wide difference on the definition of right in different areas/contexts. For example, the following are some definitions given to "right" by different theorists: "to have a right is to have a "valid claim"- Joel Feinberg 'Doing & Deserving; Essays in the Theory of Responsibility' (Princeton University Press, 1970) p. 257; ""in the strictest sense" all rights are claims"- Wesley Newcomb Hohfeld 'Fundamental Legal Conceptions as Applied in Judicial Reasoning and Other Legal Essays' (Yale University Press, 1919) p. 36; "a right, in the most important sense, is the conjunction of a freedom and a claim-right"- John Leslie Mackie 'Can There be a Rights-Based Moral Theory?' in Jeremy Waldron 'Theories of Rights' (Oxford: Oxford University Press, 1984) p. 179; "rights are permissions rather than requirements. Rights tell us what the bearer is at liberty to do, not what he must or must not do"- Robert B. Louden 'Rights Infatuation and the Impoverishment of Moral Theory' (Journal of Value Inquiry, Vol. 17, Issue 2, 1983) p. 95; "no one ever has a right to do something; he only has a right that some one else shall do (or refrain from doing) something"- Glanville Williams 'The Concept of Legal Liberty' in Robert S. Summers ed., Essays in Legal Philosophy (Berkeley: University of California Press, 1968) p. 125; "a right is an established way of acting"- Rex Martin 'A System of Rights' (Oxford University Press, 1993) p. 1; "a person who says to another 'I have a right to do it' is not saying that ... it is not wrong to do it. He is claiming that the other has a duty not to interfere"- Joseph Raz 'Ethics in the Public Domain' (Oxford: Oxford University Press, 1994) p. 275; "it is hard to think of rights except as capable of exercise"- H. L. A. Hart 'Essays on Bentham: Jurisprudence and Political Philosophy' (Oxford: Oxford University Press, 1982) p. 185; "a right is a power which a creature ought to possess"- John Plamenatz 'Consent, Freedom, and Political Obligation' (Oxford: Oxford University Press, 1938) p. 82; "all rights are essentially property rights"- Hillel Steiner 'An Essay on Rights' (Oxford: Blackwell, 1994) p. 93; "rights are themselves property, things we own"- Joel Feinberg 'Social Philosophy' (Prentice-Hall, Englewood Cliffs, 1973) p. 75. For a survey and a brief discussion on different features of "right" in western terminology see Leif Wenar 'Rights and What We Owe to Each Other' (The Journal of Moral Philosophy, 2011).

<sup>109</sup> As per New York's business corporation law, a contribution may be made in the following ways: money (cash or cheque); tangible or intangible property; labour or services already performed for the corporation; a binding obligation/promise to pay in the future in money or property; a binding obligation/promise to perform future services having an agreed value.

reputation, technology, and know-how or any other forms of intellectual property. Capital and equipment, or any other forms of physical property and chattels are considered tangible contributions. In partnership/business forms, gains have to be shared in proportion to the contributions made to the business scheme by different participants. This is how the competing interests of different participants<sup>110</sup> would be balanced in an equitable and just manner. This understanding is obviously contrary to the dominant corporate laws where employees receive fixed remunerations and the business shareholders utilise all the profits.

This wide definition of contribution would enhance efficiency. It would encourage people/investors to get together and create more value because they understand that they would benefit from direct participation in group economic activities by way of their contribution in whatever form they can do it - whether it be in the form of intangible or tangible. Obviously, this view differs from the modern economic policies and moves away from the dominant role of capital in the economy. This new approach is more efficient and, in addition to the fact that it fosters community, it furthers the economic development simply because it recognises new types of contributions and makes it possible to mobilise and use the different talents and abilities of people in the development process of the economy.

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<sup>110</sup> It may be said that in all economic (business/partnership) groups e.g., enterprises, the community and society is also considered a contributor. The society as a whole provides a secure business environment and other social protections. Therefore, for their contributions, the community and society have to be compensated and benefit proportionally according to the contribution made to the business enterprises. The activities of enterprises should always be beneficial to the society as a whole, otherwise they should be prevented from occurring (because a business enterprise cannot operate to the detriment of its contributor/stakeholder). The right of society can be compensated in the form of tax (zakat) or in any other appropriate ways.

In a balancing test, the opposite side of rights/benefits is duties/burdens.<sup>111</sup> To be just and equitable, one's duties have to be in balance with one's rights. Therefore, distribution of burdens/losses follows distribution of benefits/profits. In the event of a business loss, the entire loss shall be borne by all participants in proportion to their contributions. However, the entire pecuniary loss will have to be shouldered solely by providers of the tangible contribution and the loss of intangible providers is that they will gain nothing.<sup>112</sup> As per the *Quran*, the limit to one's duties or burdens is the point at which one's ability is in its ultimate capacity.<sup>113</sup> Debtors are obliged to satisfy their duties to their full capacity, i.e., with their entire assets and properties minus the cost of their basic living necessities. Debtors cannot limit their liability as long as they are able to honour their obligations. It is not permitted that the creditor is left unsatisfied if the debtor is able to satisfy his debts considering the debtor's full capacity.<sup>114</sup> Otherwise, it will be seen as unjust enrichment.<sup>115</sup>

On the basis of the above understanding, a standard liability rule in a business context has to be shifted from the current dominant limited liability rule to an

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<sup>111</sup> In western terminology, an "obligation" is often defined as a claim arising out of some specific relation between two or more parties, resulting from the *consent* or *conduct* of one or some of them, which gives the other party or parties to ask for some definite act or forbearance from the other party or parties to the relationship. See Frederick Pollock 'First Book of Jurisprudence' (Burt Franklin Publisher, 1967) p. 87. Some scholars have provided the most fundamental division of obligations by the terms *declared or consensual* on the one hand and *prescribed or constructive* on the other hand. The term "*consensual*" shows the will or declaration of assent by one or some parties, whether expressed or implied. The term "*prescribed*" is to indicate all those obligations which are fixed and imposed by law regardless of consent or voluntary assumption, such as quasi contracts and constructive trusts. See Henry W. Ballantine 'Classification of Obligations' (Canadian Law Times, Vol. 41, Issue 6, June 1921) p. 438.

<sup>112</sup> However, in bankruptcy cases, where the debt obligations of the collective scheme go beyond the entire contributions, the intangible contributors will also be liable towards the enterprise creditors in proportion to their contributions made to the collective scheme.

<sup>113</sup> The Quran (2: 286)

<sup>114</sup> There is some interesting Sharia evidence on this, although it is not directly relevant. As per the Quran (83: 1&3) "It is not just and fair, if those who, when they take from others by measure or weight, take their full share; but, when they measure or weigh for others, give less than their due".

<sup>115</sup> See the Quran (4:29).

unlimited proportionate liability norm. Under the unlimited proportionate liability rule, receivers of the profits of business shall share the liability of the business proportionately and *pro rata* provide full compensation to any harmed parties. In contrast to this, as per the modern limited liability standard, a participant of a business activity avoids bearing a loss greater than his amount of contribution to the business enterprise. Under limited liability governance, if the business enterprise incurs a loss and becomes insolvent, the loss cannot go beyond the contributed capital of the investor, and if the liquidated value of the assets of the business enterprise are not sufficient to satisfy all its debt obligations, the creditors of the business will have no right of recourse to the personal assets of the investors for the rest of their claims.<sup>116</sup> It thus becomes clear that the application of the limited liability rule would in some circumstances lead to the legitimisation of unjust enrichment, which is not only prohibited in *Sharia*<sup>117</sup> but also disallowed in many jurisdictions.

Legalising the limited liability standard has persuaded businesses to establish unlimited separate legal entities to carry out their highly risky business activities through these entities and do not take into account the negative externalities of their adventurous activities. Their sole concern is in fact to maximise their profits as much as

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<sup>116</sup> As a general rule, even the directors of the business entity who might have been responsible for the insolvency of the business, are not held responsible towards the entity creditors for the rest of their receivable debts.

Despite the application of a proportionate liability standard, it is not however (for practical considerations) wrong to implement a joint & several liability initiative in favour of the creditors of the business collective scheme. However, any contributor will ultimately be held liable proportionately according to his contribution.

<sup>117</sup> See the Quran (4:29) “do not devour one another’s belongings illegitimately i.e., without the valid consent of the property holder”.

they can at the expense of others,<sup>118</sup> no matter how injurious their self-interest is to society as a whole.

Another persuasive argument against limited liability in a business environment is that the higher the level of business activity, the more precautionary measures are required to reduce the probability of risk in the market especially to avoid systemic risk. In other words, the level of liability should be adjusted with the level of economic activity in the society. Surprisingly, the liability standard for businesses whose level of activity obviously goes much beyond that of non-businesses and individuals is lower than the liability standard set for the latter group whose level of activity and systemic risk is much lower than the former group.

As per Taqi Usmani,<sup>119</sup> even though there is no express mention of the concept of limited liability in the original sources of *Sharia*, the viewpoint of Islamic *Fiqh*<sup>120</sup> regarding limited liability may be derived by way of inference by doing some sort of *ijtihad*<sup>121</sup> from the principles found in the *Quran*, the *Sunnah*<sup>122</sup> and Islamic jurisprudence. As for his initial thinking he argues for the legitimacy of limited liability in *Sharia*. However, he mentions that this is neither his final conclusion nor a definite opinion and it requires further research to verify it. In his reasoning on limited liability, he argues that its legitimacy is closely linked to the notion of the legal personality of modern business enterprises which are treated as separate entities and as fictitious persons holding the same legal status of a natural person in all their dealings.

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<sup>118</sup> However, in order to avoid the distortion of competition in the market, some detrimental business behaviours are prohibited in modern antitrust/competition laws and practices, such as in the US Antitrust Law and EU and UK Competition Laws.

<sup>119</sup> See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) pp.150-160.

<sup>120</sup> Islamic jurisprudence

<sup>121</sup> It means a Sharia expert's reasoning to find appropriate rules for new problems following the underlying Sharia principles.

<sup>122</sup> It means the authenticated practices and sayings of the Prophet Muhammad (and his companions).

Therefore, the major challenge in this regard, according to him, is whether the theory of the “juridical person” is acceptable under *Sharia* or not. If it is concluded<sup>123</sup> that the “juridical person” is in fact acceptable from a *Sharia* viewpoint - which in fact it is, the logical result will be to accept the notion of “limited liability”.<sup>124</sup> Also according to him, it is a logical result because when a natural person dies insolvent, the claim of his creditors will be limited to the estate of the indebted deceased and the same rules will apply to an insolvent business entity. After insolvency, the business entity will be liquidated and the liquidation of a business entity is comparable to the death of a natural person simply because a business entity can no longer exist after its liquidation when its legal life terminates.

Some Islamic scholars<sup>125</sup> have noted that there have been some important practices that are treated in *Sharia* as separate entities and can be used as evidence of

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<sup>123</sup> Taqi Usmani argues that there are some compelling precedents from where the notion of juridical person may be inferred by *ijtihad*. See Muhammad Taqi Usmani ‘An Introduction to Islamic Finance’ (Hague: Kluwer Law International, 2002) pp.150-160.

<sup>124</sup> For some discussion in this regard see Muhammad Taqi Usmani ‘The Principle of Limited Liability from the Shariah Viewpoint’ (New Horizon, Aug-Sept 1992) p. 22.

<sup>125</sup> For more detail and the arguments for and against the limited liability see Imran Ahsan Khan Nyazee ‘Islamic Law of Business Organization: Corporations’ (Islamabad: The Islamic Research Institute Press, vol. 2, 1998) pp. 104, 117; Nabil Saleh ‘Arab International Corporations: The Impact of the Shari’a’ (Arab Law Quarterly, vol. 8, 1993) p. 180. As per Foster, there is no strong authority in *Sharia* to support the existence of a Western-style (i.e., comparable to the West) concept of legal personality as well as limited liability in Islamic law. He also warns that the comparison of rules between *Sharia* and Western law can lead to dangerous consequences if the comparison is made without taking the context into account. See Nicholas H. D. Foster ‘Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical *Sharia* and a Brief Comparison of the *Sharia* Regimes with Western-Style Law’ (*European Business Organization Law Review*, vol. 11, issue 1, 2010) pp. 32-33. For a deeper discussion on legal personality and limited liability see also Nicholas H. D. Foster ‘Islamic Perspectives on the Law of Business Organisations II: An Overview of the Classical *Sharia* and a Brief Comparison of the *Sharia* Regimes with Western-Style Law’ (*European Business Organization Law Review*, vol. 11, issue 2, 2010) pp. 283-288.

a juridical person in Islam. These important practices are *waqf* (endowment),<sup>126</sup> *a'qila*<sup>127</sup> (members of a tribe responsible for paying the blood money on behalf of a member-murderer of the tribe), the mosque, *baytul maal*,<sup>128</sup> *ma'taraka mutawaffa*,<sup>129</sup> and also the "limited liability of the master for debts arising out of his slave's activities".<sup>130</sup> However, it may be argued for the following reasons, that none of these are strong enough evidence as to the existence of limited liability in *Sharia* especially in business and finance context. Firstly, all the above mentioned religious institutions or legal precedents are implemented in not-for-business context except the last one. It is argued that when slavery was historically in fashion, there was a kind of slave who was used as trade intermediary tools and provided with an initial capital by their masters to carry out trade. The ownership of seed capital remained entirely with the master and whatever income the slave earned belonged exclusively to the master. If in the course of trade, the slave incurred debts and the amount of initial capital plus income were not enough to set off the debt obligations, the creditors had a right to sell the slave

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<sup>126</sup> Waqf is an endowment, which consists of the surrender or detention of a property and the devotion or dedication of its profits to some good causes. For arguments made against the existence of legal personality in waqf see Timur Kuran 'The Absence of the Corporation in Islamic Law: Origins and Persistence' (American Journal of Comparative Law, vol. 53, 2005) pp. 822-823. See also Imran Ahsan Khan Nyazee 'Islamic Law of Business Organization: Corporations' (Islamabad: The Islamic Research Institute Press, vol. 2, 1998) pp. 104, 117.

<sup>127</sup> See Iran Islamic Criminal Code articles 221 and 260.

<sup>128</sup> Baytul Maal literally means "public treasury". It also means the Islamic state exchequer.

<sup>129</sup> It means the estate left by a deceased person.

<sup>130</sup> See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 39. Murat argues that there are some clues in the writings of the Islamic medieval jurists which show the existence of "judicial personality" in Islamic law e.g., mosques, waqfs (he argues that waqf itself, on the name of waqf can borrow and lend), and baytul maal are considered to hold separate judicial personalities. See also Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) pp. 150-160. Concerning the application of juridical personality in sharkat or a partnership context, Buyukcelebi argues that, for example in sharkat al-inan, if the sharkat/partnership is established on the basis of kifala (personal surety) it will be considered to possess judicial personality (simply because in kifala "all real person transactions" can also be fulfilled by the partnership), but if it is formed on the basis of wakala (agency) it will not be considered to have judicial personality. See Ismail Buyukcelebi 'Islam Hukukunda Inan Sirketi va Nevileri (Erzurum: Ataturk Universitesi Doktora Tezi, 1981), p. 76.

and recover their claims out of the acquired price. However, if the claims were not settled even after sale of the slave, the creditors did not have a right of recourse to the personal assets of the master for the rest of their claims. Assuming the mentioned practice of slavery in the initial period of Islamic history, the policy of Islam was to abolish any form of slavery practice and it was finally brought to an end. Therefore, the rules of slavery practice are inapplicable today. Secondly, they are themselves not strong enough to prove the salient features of a “juridical person” as it is practiced in contemporary practices. Finally, even assuming the existence of the notion of “juridical personality” in *Sharia*,<sup>131</sup> it does not necessarily prove the validity of limited liability in Islam especially in the context of business activities. After all, however, it seems the precedents mentioned above are somewhat acceptable to show the legitimacy of juridical personality or separate legal entity in *Sharia* but in a very limited concept (which is by far different from what is practiced and understood of legal personality today). The acceptable legal personality from the viewpoint of *Sharia* is merely for practical considerations and it may not be used to contravene any injunction of *Sharia*.<sup>132</sup>

Having examined the concept of benefits as well as burdens in the research on the burdens-and-benefits balance theory, the last important issue about the theory is

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<sup>131</sup> As per Sanusi, a juristic person is not prohibited in *Sharia* and the Islamic legal system does truly recognise the concept of judicial personality with no objection. The legal personality of waqf and baytul maal has been recognised for centuries in the practices of *Sharia*. See Mahmood Mohamed Sanusi ‘The Concept of Legal Entity and Limited Liability in Islamic Legal System’ (Malayan Law Journal, vol. 3, 2009).

<sup>132</sup> Taqi Usmani believes that the notion of ‘limited liability’ should not be utilised for the purpose of deceiving people and avoiding the ordinary liabilities resulting from a profitable business. He suggests that it would be fair if its use is restricted to public companies, but as for private companies or partnerships, it would not be justifiable to apply the concept of limited liability with a possible exception for the sleeping partners in a partnership or the shareholders of a private company who do not in practice participate in the conduct or management of the business. See Muhammad Taqi Usmani ‘An Introduction to Islamic Finance’ (Hague: Kluwer Law International, 2002) pp.150-160.



the application of the balancing test:<sup>133</sup> the strength of benefit/interest versus the magnitude of burden/harm as a result of the exercise of one's rights. The balancing test is met when the entire external effects outweighed by legitimate benefit and interest of the one who exercises his rights (and also the benefits for society), taking into account less burdensome alternatives i.e., restrictive means. To determine whether conducting a given economic behaviour or business transaction is acceptable, an extensive cost-benefit analysis test is applied, i.e., the potential benefits (positive externalities: whether it be pecuniary or not) resulting out of the business or economic conduct has to be weighed against the potential burdens (negative externalities: whether it be pecuniary or not)<sup>134</sup>. To be socially acceptable,<sup>135</sup> the usefulness of the conduct to the society must outweigh the severity of the potential harms to the society.<sup>136</sup> In other words, in circumstances in which the unreasonable and substantial interference with the rights of others or the interests of society as a whole outweighs the individual and social utility of the business conduct, the concerned business activity has to be prohibited and must be capable of being enjoined by a court injunction.<sup>137</sup> Generating profits by hurting others or by violating the basic rules and principles of society is condemned as a wrongful conduct.

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<sup>133</sup> As mentioned before, (social) interest (masaalih) is considered a very important factor in the outcome of a balancing test.

<sup>134</sup> See the Quran (2:219) "they ask you about drinking and gambling. Say, there is great harm in both, though there is some benefit also for the people. But the harm thereof is far greater than their benefit...".

<sup>135</sup> There would however be some difficulties with the notion of "socially acceptable/responsible activity". The problem is its subjective nature. Different people will have different conceptions and assessments about what constitutes social acceptability/responsibility. To tackle this subjectivity concern, a transparent and methodological screening process has to be introduced.

<sup>136</sup> It may be further argued that to be legitimate and socially acceptable the given business/economic activity of an investor has to bear some social utility and make a positive contribution to the society (in addition to benefiting the investor himself).

<sup>137</sup> As per the Constitution of Iran article 40 "no one is entitled to exercise his rights in a way that is injurious to others or detrimental to public interests".

Accordingly, balance of harms has to be taken into account in the permissibility of a business transaction or an economic activity; thus, a party or the society seeking a preliminary injunction to deter the performance of a given business transaction or economic activity must show that the threatened injury to them (arising out of the prospective act) outweighs the injury to the party seeking to carry out the business (if he forbears the exercise of his right). Also, in cases where a party (not the society) seeking a preliminary injunction argues that the given business product is “defective” (i.e., wrong, needlessly dangerous or unavoidably hazardous), they must show that the injunction would not adversely affect the public interest.<sup>138</sup> For example, consider that a new financial institution is set up to provide financial services. However, the establishment of this new institution is detrimental to the interests of the previously established financial institutions but is a socially desirable business because it furthers social interests. In this scenario, although the previously existing institutions suffer an “opportunity loss”<sup>139</sup> it would not be recoverable either from the new institution nor the society.

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<sup>138</sup> For a similar analysis see *Muneer Awad v. Paul Ziriak et al.*, Case No. CIV-10-1186-M, U. District Court for the Western District of Oklahoma (9 November 2010), pp. 14-15. Text of decision available via the Internet at [http://www.politico.com/static/PPM152\\_101109\\_shariah\\_tro.html](http://www.politico.com/static/PPM152_101109_shariah_tro.html) (accessed 10 July 2011). See also *W. Va. State Bd. of Educ. v. Barnette*, 319 U.S. at 638 (1943).

<sup>139</sup> This kind of “opportunity loss” does not fall within the scope of “loss” (darar).

## 1.8 The First Tier of the Model (3): The Fundamental Principles and Policies

The fundamental principles and policies which govern just distribution of primary wealth and proper circulation of subordinate wealth are derived from the ultimate objective and foundational theory of the thesis. A very fundamental principle is that that the equitable distribution prevails over efficiency rule. On this basis, in case there is any conflict between distribution and efficiency rules, the distribution policy will override the efficiency theory. This is simply because the social balance and consequently the just distribution of wealth in a human society are given priority over the concentration and maximization of material wealth.

Regarding the distribution of natural wealth resources, every human being is entitled to enjoy and benefit from natural wealth resources entrusted to them by the absolute owner (the Creator) yet nobody can claim to be the beneficiary of a specific part of the natural wealth until it is distributed in a legitimate manner. All human beings should enjoy the proceeds of natural wealth according to their reasonable and legitimate needs and, regarding some natural resources, in proportion to their contributions made such as according to their work efforts for utilisation of the wealth resources. However, people can never acquire the ownership of these wealth resources and it remains always under the control of the public as a whole.<sup>140</sup>

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<sup>140</sup> The major natural wealth resources are lands, minerals and natural water bodies. These natural resources (immoveable) are known as the “origins” of wealth (also called *raqabat al-maal*) that the ownership of which can never be acquired by the people individually. For a detail definition and the scope of natural wealth resources see Muhammad Hasan al-Najafi a.k.a al-Muhaqqiq al-Najafi ‘Jawaahir al-Kalaam fi Sharh Shara’e al-Islam’ (Daar al-Kutub al-Islamiyyah, vol. 16/43, 2<sup>nd</sup> edition, 1362 Solar Hijri Calendar) p.132. See also Muhammad Baqir Sadr ‘Iqtisaduna’ (Qom: Bustan-e Ketab-e Qom Press, 2003) pp. 419-469, 471-493, 495-498.

Consequently, the people are unable to transfer the ownership and control of these wealth resources to anybody else including the state.

With respect to profit-making products and collective schemes, distribution of ownership, profits, losses and liability is made according to the amount of contribution made by every participant to a given business activity. Ownership and control unity is applied. There is no room for the application of currently dominant limited liability norm and instead an unlimited proportionate liability standard is implemented. This change is to follow the rules of balancism and also discourage taking highly risky business activities which may cause devastating systemic instabilities. The application of legal personality concept is adopted due to practical concerns but only for very limited purposes. Profit and loss sharing arrangement is implemented instead of modern labour employment practice; in other words, employer-employee relationship structure is abolished in business environment.

Concerning the not-for-profit activities, the House of Wealth is in charge of securing basic essential needs of members of the public such as a dwelling house, education and health care facilities and the provision of basic infrastructure utilities. The supply of not-for-profit facilities made by anybody is essentially to help others free of charge and for some good purposes.

As regards microbusiness activities, microfinance tools and products are designed to empower poor to obtain their economic independence in order for transmitting them from the bondage and dependence status to self-reliance and independence level. The instruments designed for microbusiness purposes are basically cooperative-oriented schemes seeking to foster a spirit of cooperation.

With regard to intermediary tools and services, in cases where an intermediary is used for not-for-profit purposes the intermediary has to be rewarded on fixed-compensation basis and in the case of using the services of an intermediary for profit-making purposes the intermediary has to be rewarded on sharing-in-benefits basis.

Payment and deposit intermediaries that are set up to provide services such as funds transfer and exchange services will receive only service fee in return for the provision of intermediary services. The ownership and control of the payments and deposits, unlike the modern banking practices, always remain with the customers and depositors themselves. This change is to follow the rules of just distribution of wealth and mainly to prevent concentration of wealth which may lead to systemic instability problems.

In connection with risk hedging tools and facilities, the philosophy and underlying rationale for risk insurance is to minimise risk rather than taking advantage of risk and trading in it. The institutions and collective schemes that are established to provide risk hedging services should not be allowed, unlike modern insurance and risk hedging practices, to get involved in investment and trade activities. This change is mainly to avoid the inflation of risk which may essentially cause systemic instability concerns.

## **Chapter Two:**

# **Key Concepts and Their Implications in Islamic Law**

## 2.1 Introduction

Islam<sup>1</sup> is a religion originating in its current form in Arabia in the 6th/7th century AD. To understand the inner dimensions of Islam, it is necessary to examine the Islamic intellectual heritage<sup>2</sup> in depth. This goes much beyond *Sharia*, and is out of the scope of this thesis. If Islam is considered to be an ocean, its shoreline is *Sharia*. In other words, *Sharia* is the touchstone for whether an act is within or external to, the religion

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<sup>1</sup> "Islam" is an Arabic word. It means that one's life should be according to the will of God.

<sup>2</sup> What is meant by Islamic intellectual heritage is 'the ways of thinking about God (absolute), the world, and human beings - established by the Quran and the Prophet and elaborated upon by generations of practising Muslims'. For more see William C. Chittick 'Can the Islamic Intellectual Heritage be Recovered?' (1998) Available via the Internet at <http://www.allamaiqbal.com/publications/journals/review/oct98/2.htm>. As per Chittick (pp. 4, 10-11), Islamic intellectual heritage has mostly been lost in the modern world. According to him, modern "intellectual forces", and modern "attitudes and social forces" have come to be two major obstacles to the recovery of Islamic heritage. The former are closely connected with the methods of thinking that developed in Western Europe and America and now dominate the modern world ("the gods of modernity"). These gods of modernity have now been internalised by modern-day Muslims, who have either enthusiastically adopted them as their own or been exposed to them without their choice or awareness. The former have in turn given rise to the latter ones i.e., "attitudinal obstacles" across the Islamic society that prevent recovery of the Islamic heritage. These sorts of attitudes and habits of mind have now become embodied in and dominate the institutions and frameworks of modern society. Unlike the Islamic view in which God's prophets share tawhid ("asserting that the God is one"), the great prophets of modernity- Descartes, Rousseau, Marx, Freud- reject tawhid and they argue for takthir ("asserting that the gods are many"). The fact is that one can only reject God's oneness by inventing new gods to replace Him. God's prophets all focused on theology (rooted in tawhid), in contrast to the modern prophets whose focus have been on science (rooted in takthir). The former looks down from above and can easily understand the interconnectedness of all things in the world, while the latter is stuck on the level of multiplicity- the lowest scope of reality- and its main concern is to dissect this multiplicity for new inventions. As per its own premises, the invisible domains do not fall within the scope of science (but, in theology these sorts of domains- including the God itself that is indeed the major invisible domain, called ghayb- are given special consideration. Modern times and modern thought- contrary to Islamic thought that (up until recent times) is characterised by a tendency toward unity- lack any single purpose. The consequence is an ever-increasing multiplicity of purposes and ever-increasing clashes of different desires.

of Islam<sup>3</sup>. *Sharia* is an extensive web of rules and recommendations touching on all aspects of the lives of human beings. It directs Muslims and often the people in general, how to behave individually and collectively.

## 2.2 The Concepts of “Must Do” (*Amr*) and “Must Not Do” (*Nahy*) in Islam<sup>4</sup>

Islam has ruled some specific acts as prohibited (*haram*) acts, and recommended some specific acts as abominable (*makruh*) acts. Major prohibited acts or those subject to *nahy* include: *riba* (an excess in the exchange of exact same products, such as the exchange of money against money or wheat against wheat with some excess taken from one of the parties to the exchange); *ghabn* (intolerable imbalanced loss, mainly as a result of unconscionability in a transaction); *gharar* (unnecessary disproportionate risk and excessive uncertainty); *qimar* (gambling); *maysir* (speculation/betting); *israf* (consumption or spending beyond the reasonable needs); *itlaf* (consumption or expenditure with no need to do so); *ihtikar* (hoarding); *inhisar* (monopoly); and *istithmar* (exploitation of another’s right/contribution especially another’s labour).<sup>5</sup> A specific abominable or at least one that is recommended to avoid is being involved in the funeral business. In contrast, Islam has ruled some specific acts as *wajib/fard* (must

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<sup>3</sup> In the thesis, whenever “Sharia” is referred to it means the Islamic canonical texts (substantive sources) i.e., Quran and Sunnah, including the Hadith literature. Whenever the term “Islamic law” is used in general it includes not only the Islamic canonical texts i.e., Sharia but also the primary methodological sources of law in Islam (these methodological sources i.e., the techniques that have been devised to develop Sharia will be discussed shortly).

<sup>4</sup> In general, in Islam, human acts are divided into: *ibadat* (spiritual acts) and *mua’malat* (economic, business, and financial acts). The concern of the research project is the latter ones but not the former ones. The rules of *amr* (must do) and *nahy* (must not do) governing *ibadat* and *mu’amalat* are different and they may render different effects.

<sup>5</sup> For some regulatory support in this regard see the Constitution of Iran article 43 (sections 4-6).



do or obligatory) acts i.e., the acts subject to *amr*, and recommended some specific acts as *mandub/mustahab* (recommended to do) acts. The main obligatory (*wajib*) acts are respect for the rights of others, returning deposits under custody, satisfaction of due debt obligations, and doing work and business for the fulfillment of the basic needs of family. Recommended to do (*mustahab*) acts in Islam are doing any business and economic activities that are useful for society as a whole. All the remaining acts that are not rated in one of the above four categories are deemed *halal/mubah* (permissible) acts.

There are several important points with regard to *amr* (“must do”) and *nahy* (“must not do”) orders in Islam. In some cases, the proper legal sanction relating to the “must do” or “must not do” orders is not clear. The civil sanction in *Sharia* is *batil/faasid* i.e., invalid/void (vis-à-vis *sahih/naafiz* i.e., valid), and the criminal sanction is *ma’siyat* (sinful). However, it should be noted that an act e.g., a business transaction, may be considered a grave and sinful (*ma’siyat*) act, for which the violating investor would be responsible in the Hereafter (*qiyamat*); but, this sinful act would not necessarily always render the business transaction void (*batil*).<sup>6</sup>

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<sup>6</sup> For details on different views on the legal sanctions of *amr* and *nahy* see Mirza Abulqasim Qomi ‘Qawanin al-Usul’ (Tehran, chap-e sangi, vol. 1) p. 154. He states five different views in this regard. See also Abulqasim Kalantari (Taqrirat Murtaza Ansari) ‘Mataarih al-Anzar’ (chap-e sangi) p.16. He mentions ten different ideas in this regard. As per some Islamic jurists such as Mirza Naeeni, the purpose of *amr* and *nahy* rules is to warn people of the benefits (*masaalih*) and risks (*mafaasid*) of their acts. That is why it is argued that in general the philosophy of Islamic rules is cost and benefits analysis. See Muhammad Ali Kazimi (Taqrirat Mirza Hussein Naeeni) ‘Fawaeed al-Usul’ (Muassese Nashr Islami) pp.221, 471-472. He also distinguishes two different *nahy* (must not do): *nahy irshadi* and *nahy mawlawi*. According to him, the former *nahy* invalidates the relevant transaction entirely, but the latter invalidates only the effects in certain circumstances but not the possibility and permissibility of its formation forever e.g., ordering not to do business when calling for prayer i.e., *salat* (in other words, doing business is a permissible act but it is not enforceable if it is done at the time of calling for prayer).

## 2.3 The Nature and Definition of Right (*Haq*) vis-à-vis Duty (*Taklif*)

Islamic rules are closely connected with the concept of *huquq* (rights) and *takalif* (duties) of human beings, that is to say the definition of *haq* (right) and *taklif* (duty) under *Sharia*. That is why the starting point in Islamic law must be centred on the concept of *haq vis-à-vis taklif*.

According to Islam, in a more particular context, *haq* is defined as the power that a person holds, according to law, over another person or property or both - whether it is material, such as a right of tenancy, or intangible and non-material, such as an intellectual right.<sup>7</sup> In a more general context, *haq* means everything that God<sup>8</sup> or anybody on behalf of God has granted to a person including rights with a more specific meaning, and also includes *takalif*.<sup>9</sup> To address the concept and the scope of law<sup>10</sup> as it is understood in the modern sense, the provided second general definition of *haq* seems to be a more suitable and comprehensive one.

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<sup>7</sup> This is the definition of *haq* (right) as per the Shia school of thought. For a similar definition see Sayf Allah Isfahani 'Bulghat al-Faqih' (chap-e sangi, 1328 Lunar Hijri Calendar) p.3; Musa Najafi (Tagrirat Mirza Hussein Naeini) 'Monyat al-Talib' (Qom: Ahmadiyya, chap-e sangi, vol. 1, 1373 Lunar Hijri Calendar) p.41; Muhammad Kazim Tabatabaee (bi-khatte Zayn al-A'bidin) 'Hashiye bar Makasib' (chap-e sangi, 1326 Lunar Hijri Calendar) pp. 54-56.

<sup>8</sup> As per Islamic scholars, the true legislator in Islam, called *Shaare*, is God. That is why the recognition of God as the only qualified legislator (*Shaare*) and consequently the recognition of God's unique characteristics is a very necessary step in understanding Islamic law. See Abi Hafs Umar bin Muhammad al-Nasafi (a.k.a. Masoud bin Umar Taftazani) 'Sharh al-Aqaeed al-Nasafiyyah' (chap-e Usmani, 1326 Lunar Hijri Calendar) p.112.

<sup>9</sup> See Musa Najafi (Tagrirat Mirza Hussein Naeini) 'Monyat al-Talib' (Qom: Ahmadiyya, chap-e sangi, vol. 1, 1373 Lunar Hijri Calendar) p. 41.

<sup>10</sup> In Islamic terminology, the word that is used to equate law is *huquq*.

## 2.4 The Implications of Right

According to Islamic jurisprudence, in the *Shia* school of thought,<sup>11</sup> the major effects or salient features of *haq* albeit in its more particular meaning are that it can be waived; for example, the waiver of a receivable debt by a creditor;<sup>12</sup> and also that it can be transferred both in an active way (e.g. a sale)<sup>13</sup> and a passive one (e.g. inheritance)<sup>14</sup>.

## 2.5 The Origin of Right

With regards to the origin of *haq* (right), Islamic scholars' opinions are divided into two general categories.<sup>15</sup> There are the "free will" advocates who are of the view that the function of law is only to limit the scope of freedom of the will of people and nothing more. According to this idea, *haq* is not given by law to the people though it

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<sup>11</sup> See Muhammad Kazim Tabatabaee (bi-khatte Zayn al-A'bidin) 'Hashiye bar Makasib' (chap-e sangi, 1326 Lunar Hijri Calendar) p. 54; Musa Najafi (Tagrirat Mirza Hussein Naeini) 'Monyat al-Talib' (Qom: Ahmadiyya, chap-e sangi, vol. 1, 1373 Lunar Hijri Calendar) p.42; Murtaza Ansari 'Makasib' (bi-chape Zayn al-A'bidin) p. 79.

<sup>12</sup> See Iran Civil Code article 289.

<sup>13</sup> See Iran Civil Code articles 338-339.

<sup>14</sup> See Iran Civil Code article 867.

<sup>15</sup> See Muhammad Ja'far Jafari Langroodi 'Maktabhaye Huquqi dar Huqug-e Islam' (Tehran: Ganj-e Danesh, 3<sup>rd</sup> edition) pp. 5-6, 65-69.

can be limited, organised or taken away under certain conditions by law.<sup>16</sup> This is the dominant idea among Islamic scholars. The “anti-free will” proponents advocate the view that any *haq* is created and granted by law and people essentially have no *haq* save that granted to them by law - i.e., by God or on behalf of the God, according to the view of Islam.

## 2.6 Different Types of Right

In respect of different types of *haq*, from one perspective, *haq* is either controlled by the will of people (*haq annaas*) or the will of God (*haq Allah*). The former are the rights which are capable of being waived by the people – these are also called private rights. For example, the property right arising out of a business activity is a private right and it can be transferred, waived, or compromised. Any right which is absolute and not capable of being waived, compromised or exchanged falls within the second category, - called public rights. From one perspective, *haq* is either claimed against an object (property) including the profits<sup>17</sup> thereon (which is called an

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<sup>16</sup> For supporting evidence see Quran (2:29) “He (God/Allah) it is Who created for you all that there is on the Earth (world)”. According to a Hadith “anything that God allowed people to do or benefit from is halal (permitted) and anything that God prohibited is haram (forbidden); regarding the things that God is silent on, then the people are free to act or benefit from them; people then may take them as they are and ask God to make it desirable for them though God does forget nothing”. It may be said that the mere silence of God and non-issuance of the rule on a necessary issue implies that the decision on the given issue has been left up to the people to decide on it (whether freely to act on it or not to act). In other words, in Islamic jurisprudence, to know whether an act is a permitted act or not, it is enough to see whether there is any specific constraint according to Islamic canonical texts or substantive law (i.e., Sharia). The absence of the Sharia constraint is enough reason to conclude that the given act is permitted.

<sup>17</sup> See Iran Civil Code article 328 “if anyone destroys the property of another person, he will be held responsible and must either produce its equivalent or its value, whether or not the object (property) was destroyed intentionally and whether it was the actual object (property) or profits thereon that were destroyed; if he causes defect or damage to such object (property), he is responsible for the depreciation in value”.

ascertained right<sup>18</sup>), or against a person (which is called a personal right<sup>19</sup>). According to Islamic law, the holder of an actual right prevails over the holder of a personal right.<sup>20</sup> The relationship of a person with an object (asset) can be in one of the following forms: a) ownership right including the ownership of the object (*ayn*) itself and/or only the profits (*manfa'at*) thereon<sup>21</sup>; b) enjoyment privilege<sup>22</sup>; and c) an easement interest in the property of someone else<sup>23</sup>. The main difference between the ownership right of profit and the enjoyment privilege is that, the former is a property or property right (i.e., an asset) of its holder and it has to be incorporated in the holder's/owner's balance sheet as per accounting rules. Consequently, the holder/owner of profits, unlike the grantee of enjoyment privilege, has a right to transfer the profits (arising out of a given object/property). In other words, the enjoyment privilege is solely limited to its grantee and he cannot transfer it to third parties. It is in this limited scope that the usurper or trespasser of the enjoyment privilege can be held liable against the owner of the relevant object (property) or profits, but not the grantee of the enjoyment privilege.

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<sup>18</sup> Examples of an ascertained right (*haq ayni*) are the right of the holder of collateral against the collateral and the right of the car owner against the car.

<sup>19</sup> Examples of a personal right (*haq shakhsi/haq dhimmi/haq dayni*) is the right of makful lah/creditor (for whom the summon of the debtor is ensured by a third party called kafil) against the kafil, who ensures the presence of the debtor when summoned by the makful lah/creditor, and also the right of madmun lah/creditor (for whom the payment of his receivable debt is guaranteed by a third party called damin) against the damin, who guarantees the satisfaction of the receivable debt of the madmun lah/creditor if the debtor defaults to pay madmun lah/creditor.

<sup>20</sup> See Ibn A'bidin 'Rasa'eel' (chap-e Usmani, vol. 2/2, 1320 Lunar Hijri Calendar) p. 194; also Ashrafi 'Sha'aeer al-Islam' (chap-e sangi) p. 290.

<sup>21</sup> *Haq al-malikiyyat*

<sup>22</sup> *Haq al-intifa'*

<sup>23</sup> *Hag al-irtifaq bi-milk ghayr*

## 2.7 Legitimacy Rules and Contextual Rules

In Islamic law, from the perspective of the content of rules, the rules are divided into two broader categories: legitimacy rules<sup>24</sup> and contextual rules<sup>25</sup>. The different types of legitimacy rules are the rules concerning: a) *wajib/fard* (obligatory acts); b) *halal/mubah* (permissible acts); c) *mandub/mustahab* (recommended acts); d) *makruh* (abominable acts); e) *haram* (prohibited acts). The different types of contextual rules are the rules regarding: a) *sabab* (cause); b) *shart* (condition); c) *maane'* (impediment/obstruction); d) *rukhsat* (no default allowed); e) *azimat* (limited default

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<sup>24</sup> *Ahkam taklifiyyah*

<sup>25</sup> *Ahkam waz'eeyyah*

allowed); f) *sahih* (valid); g) *faasid* (invalid/void); h) *tagdir al-shareeyyah* (fiction).<sup>26</sup>

Unlike the first ones, in the content of the second category rules, there are no issues concerning the recommendation, order or obligation to act or not to act in a particular way. The first category rules are originally found in the *Quran* and the *Sunnah* including

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<sup>26</sup> Note that *sabab* (cause) is different from what is called *illat tammah* (complete cause). *Illat tammah* (complete cause) equals *sabab* (cause) + *shart* (condition) + *adam-e maane'* (the absence of the obstruction or impediment). For example, according to Iran Civil Code article 370, the conclusion of the sale contract is the cause of the transfer of ownership from the seller to the buyer and vice versa. But the possibility or the power of the seller to enable him to deliver the subject matter of the sale contract (goods, etc) to the buyer is a condition to give an effect to the cause (the conclusion of the contract). The legislature/law might sometimes not give an effect to the contract despite the existence of both the cause and condition. In other words, under some circumstances and for the protection of public interests, the legislature might impose an obstacle or an impediment on some transactions. For example the legislature might not allow the sale and purchase of some specific goods. In this case, because of the impediment imposed by the legislature, the contract cannot be effective.

Any transaction/act that complies with the rules and regulations in effect is considered a *sahih* (valid) transaction/act, but if it violates the rules and regulations in effect it is ruled a *faasid* (invalid/void) transaction.

From one specific perspective, according to Islamic law, *haq* is sometimes taken into account vis-à-vis *hukm* (mandatory rule). In these circumstances, what is meant by *haq* is a "default rule", which can be ignored or waived. *Hukm* (mandatory rule), in turn, is divided into two categories: rules that can never be violated or circumvented (called *azimat*) and the rules that can in some cases be avoided or circumvented for necessary needs or urgent and exigent situations (called *rukhsat*). For the supporting evidence as to the latter rules (*rukhsat*) see the *Quran* (2:185) "Allah wants to show leniency to you and does not desire to show any hardship"; (5:6) "Allah does not desire to impose any hardship upon you"; (22:78) "He has not imposed upon you any hardship in religion"; (4:28) "Allah wants to lighten your burdens, for human being was created weak"; and for more see *Quran* (24:61); (33:38 & 50); and (48:17).

In Islamic scholarship, it is argued that *tagdir al-shareeyyah* (Sharia fiction) is also a type of contextual rule. However, it can be in two different forms: one is when an inexistent thing is presumed to be in existence or another is when an existing thing is presumed to be inexistent. Regarding the former one, for example, consider that the legislature presumes an existing thing in the past whose existence is now under doubt, still to be existing (called *istishab*; the presumption of continuity). With regard to the latter one, consider that the legislature gives retroactive effect to the termination of a contract and it is deemed null and void from the beginning and not from the time of the termination of the contract (called *atf bima sabaq*).

There is no uniformity and consensus (i.e., *ijma'*) among Islamic scholars in respect of the number of contextual rules in Islamic law. However, the major contextual rules are those that were explained above. For more on contextual rules see Muhammad Ali Kazimi Khorasani (*Tagdirat-e Mirza Hussein Naeeni*) 'Fawaeed al-Usul' (Najaf, chap-e sangi, vol. 4, 1339 Lunar Hijri Calendar) p.147; Ahmad bin Idris (a.k.a. Qaraafi) 'Alfuruq' (Dar Ihya' al-Kutub al-Arabiyyah, vol. 1, 1<sup>st</sup> edition, 1344 Lunar Hijri Calendar) p. 161.

the *Hadith* literature, but the second category rules have been introduced gradually by the state (legislative body) or through the juristic inferences or interpretations of the *Sharia* experts<sup>27</sup> in order to protect the public interest and/or respond to the ever-changing needs of the society. In other words, the second category rules have to be introduced and also changed contextually within the framework of *Sharia*. The second category rules cannot violate or circumvent the first category rules. That is why when it comes to determining whether a given rule, act or product is consistent with Islam or not, it is necessary to examine its compliance or compatibility with the Islamic canonical texts or substantive rules (i.e., *Sharia*), and these can be termed legitimacy rules. Legitimacy rules are inapplicable if the person does not have enough power, liberty/freedom or knowledge to follow them. Regarding the contextual rules, none of the mentioned conditions i.e., power, liberty, and knowledge need to be applied to the person. In other words, they are automatically applicable and are generally not subject to any condition, excuse or exemption. Another important point to remember is that that there is no direct relationship between the legitimacy and contextual rules.<sup>28</sup> A given action or inaction may be illegitimate, but compatible with the contextual rules and vice versa. For example, legally a debtor may give an undivided property, whose ownership belongs jointly to the debtor and his partner/co-owner, to the creditor as a pledge though it is illegitimate to dispose or possess an undivided property without the consent of the partner (co-owner).<sup>29</sup> In circumstances where it is unclear whether a given rule is a legitimacy or a contextual (legal) one, it is deemed a contextual (legal) rule simply because the legitimacy rules require an absolute basis - that they exist in the Islamic canonical texts. For example, it has been hotly debated whether the rule

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<sup>27</sup> *Mujtahids*

<sup>28</sup> Contextual rules in Islam are in fact to some extent similar to the concept of legal rules as they are understood in modern secular legal systems.

<sup>29</sup> See Muhammad Jafar Jafari Langroodi 'Huquq Madani: Sulh wa Rahn' (Ibn Sina, vol. 1, 1<sup>st</sup> edition) p.13.



that forces the performance of the undertaking promises under a given contract is a legitimacy rule or a contextual rule. Some have argued that it is a contextual rule, but some others believe that, by virtue of a canonical text found in the *Quran*,<sup>30</sup> it seems to be a legitimacy rule.<sup>31</sup>

## 2.8 The Law of Silence in Sharia

It is well acknowledged that it is not possible to predict and introduce every single necessary rule to cover all events, acts and circumstances in the present and future. The following paragraph will discuss the cases in which *Sharia* is thought to be silent.<sup>32</sup> The first case is where no rule in Islamic canonical texts is found to address a specific circumstance or problem. For example, where no specific definition of a customary practice has been provided in *Sharia*. The second is where Islam has confirmed and adopted the rules that were in practice prior to the advent of Islam. For instance, the *Quran* ratified and adopted the rule on sale contracts<sup>33</sup> that were in use prior to the rise of Islam. Thirdly, where *Sharia* has allowed the governing rule in respect of some specific cases to customary practice.<sup>34</sup> Fourthly, where the scope of a general rule has to be decided by virtue of customary practice. For example, according to the *Quran*, the validity of any business transaction and the taking of possession of a

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<sup>30</sup> As per the Quran (5:1) "... awfoo bi al-uqud ..." (honour your promises).

<sup>31</sup> See Shams al-Din Muhammad a.k.a. Shahid Awwal 'Al-Qawaeed' p.251; Muhammad Mahdi Kazimi Khalesi 'Anaawin' (vol. 2) p. 56; Muhammad Ali Kazimi Khorasani (Tagrirat-e Mirza Hussein Naeeni) 'Fawaeed al-Usul' (Najaf, chap-e sangi, vol. 4, 1339 Lunar Hijri Calendar) p.137; Ahmad bin Idris a.k.a. Qaraafi 'Alfuruq' (Dar Ihya' al-Kutub al-Arabiyyah, vol. 3, 1<sup>st</sup> edition, 1344 Lunar Hijri Calendar) pp. 131, 215-216.

<sup>32</sup> See Muhammad Jafar Jafari Langroodi 'Maktabhaye Huquqi dar Huqug-e Islam' (Tehran: Ganj-e Danesh, 3<sup>rd</sup> edition) pp. 71-78.

<sup>33</sup> See the Quran (2:275) "Allah made trade lawful/legitimate".

<sup>34</sup> "Everything that is considered desirable among the Muslims/people, it is good before God as well". See Jalal al-Din Suyuti Shafiee (tashih-e Ali Maliki) 'Al-Ashbaah wa al-Nazaeer' (Egypt) p. 80.

property by way of trading is subject to the consent of the parties.<sup>35</sup> This is a general rule introduced in the context of trade and to determine whether it is also applicable in non-business contexts, e.g., insurance dealings, it needs to be referred to and interpreted according to the commercial practices in the relevant community, industry, or society. A further case is where *Sharia* has allowed the appropriate governing rule to be one created by a reasoned understanding and decision by those living in the society; or determined on the basis of justice and equity. Some Islamic scholars<sup>36</sup> have argued that any just and equitable act, product or rule falls within *Sharia* and it is considered lawful and legitimate in Islam. The last case that will be mentioned here where *Sharia* is silent is over the rules that are deemed necessary to be accepted because of the urgent needs of the people and exigent circumstances in the society. For example, it is possible to guarantee either the purchaser or the seller against any contingent claims that may be raised by a third party in relation to the ownership of the asset of sale or the consideration respectively. This is called *daman uhda*.<sup>37</sup> This is a rule that does not exist in the Islamic canonical texts, but it has been developed due to the needs of people in society. That is why it is said<sup>38</sup> that the public need is considered an urgent and exigent circumstance and makes the necessary applicable rule legitimate. It is worth mentioning that according to the Hanafi school of thought,<sup>39</sup> any opposing customary practice that comes into use after the relevant rules/laws are in effect, overrides the relevant rules/laws although it is contrary to the laws simply

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<sup>35</sup> See the Quran (4:29) “do not devour one another's possessions wrongfully; rather than that, let there be trading by mutual consent”.

<sup>36</sup> See Ibn Qayyim al-Jawziyyah ‘Al-Turuq al-Hakamiyyah fi al-Siyasat al-Sharee'yyah’ (Cairo, 1961) p. 16.

<sup>37</sup> See Iran Civil Code article 697.

<sup>38</sup> See Muhammd Mujahid ‘Manaahil’ (Tehran, 1274 Lunar Hijri Calendar) p. 138; Shams al-Din Muhammad a.k.a. Shahid Awwal ‘Al-Qawaeed’ pp 56-57, 128; Ibn A’bidin ‘Rasa’eel’ (chap-e Usmani, vol. 2, 1320 Lunar Hijri Calendar) p. 161.

<sup>39</sup> Note that in Islam, there are two major schools of thought: Sunni and Shia. The Sunni school of thought, in turn, consists of four major schools of thought: Hanafi, Hanbali, Shafiee and Maliki.

because if the customary practice is not accepted it will cause a lot of hardship and conflict in the society.<sup>40</sup> Having discussed the issue of silence of law in Islamic law, it is worth mentioning that there are two different groups of Islamic scholars on the issue of silence of law in Islam. There are those who believe that there are some cases and circumstances where no specific canonical text in *Sharia* can be found to address the problem. The main reasons in this regard are those mentioned earlier, adding the point that the rules found in *Sharia* are limited while the events that have to be addressed by proper rules are infinite.<sup>41</sup> This is the dominant idea among Islamic scholars.<sup>42</sup> The other group rejects the silence of law problem in Islam. They argue that a comprehensive version of Islamic law, covering all necessary circumstances can be found in the *Quran* and *Sunnah* including the *Hadith* literature. However, although some *Sharia* scholars in both *Sunni* and *Shia* schools of thought support this idea, it is not, in any case, practical since the said comprehensive version is inaccessible today.<sup>43</sup>

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<sup>40</sup> See Ibn A'bidin 'Rasa'eel' (chap-e Usmani, vol. 2 1320 Lunar Hijri Calendar) pp. 130, 140-141.

<sup>41</sup> *Al-nusus ma'dudah wa al-hawadith mamdoodah*. See Shams al-Din Sarakhsi 'Al-Mabsoot' (Egypt: Sa'adat, vol. 16) pp. 62-63; Sayf al-Din Ali al-Amidi 'Al-Ahkam fi Usul al-Ahkam' (Egypt, vol. 4) p.159; Ibn Qayyim al-Jawziyyah (tashih-e Abd al-Rahman al-Wakil) 'E'laam al-Muqein' (Egypt, vol. 1, 2<sup>nd</sup> edition) pp. 375-376.

<sup>42</sup> See Muhammad Ja'far Jafari Langroodi 'Maktabhaye Huquqi dar Huquq-e Islam' (Tehran: Ganj-e Danesh, 3<sup>rd</sup> edition) p. 76.

<sup>43</sup> Some Shia jurists argue that, according to some Ahadith, a complete version of Islamic canonical texts (called Jame'a or Sahifat al-Faraed) had been explained by the Prophet to his son-in-law (i.e., Ali) and Ali had written it down at the time. But this version of the canonical book was never published due to some problems and special circumstances at the time. Also, some Sunni jurists like Ibn-Qayyim reject the problem of the silence of law in Islam. They believe that Sharia encompasses all rules that people and society need for their life and there is no need for juristic inference by analogy and any other methodological sources of law in Islam. See Abi Ishaq Ibrahim Gharnati a.k.a. Shaatibi (tashih-e Muhammad Muhyi al-Din Abd al-Hamid) 'Muwafiqat' (Egypt, vol. 3) p.246; Ibn Qayyim al-Jawziyyah (tashih-e Abd al-Rahman al-Wakil) 'E'laam al-Muqeen' (Egypt, vol. 1, 2<sup>nd</sup> edition) pp. 376, 378.

## 2.9 The Sources of law in Islam

The sources of law in Islam are either recorded writings<sup>44</sup> namely the *Quran* and *Sunnah* including *Hadith* literature or the logical conclusions and juristic understandings and judgements of *Sharia* experts demonstrated contextually in compliance with the letter and spirit of the *Quran* and *Sunnah*<sup>45</sup>. As per the *Sunni* school of thought, *fiqh* (Islamic jurisprudence that covers the different interpretations and the thoughts of Islamic jurists) takes precedence over *Sunnah* (including the *Hadith* literature). In contrast, the *Shia* school believes that Ali (who lived with the Prophet Muhammad from his earlier childhood) recorded all sayings (*Hadith*) of the Prophet Muhammad in a book called *Jame'a*, and it is believed that *Jame'a* was to be submitted by the earlier Imam to his successor and so on. Therefore, as per *Shia* thinking, it was after the full recording and preparation of *Jame'a* (i.e., *Sunnah* including the *Hadith* literature) that the *fiqh* was developed.<sup>46</sup> As per the *Shia* school of thought, the sources of law in Islam are the *Quran*, *Sunnah* including the *Hadith* literature, *ijma* (juristic consensus) and *aql* (the personal intelligent judgement). However, *ijma* is not supported by all *Shia* scholars and that is why there are some *Shia* scholars who do not support *ijma* as a separate source of law in Islam.<sup>47</sup> The same is true about *aql*. However, although *Shia* scholars initially resisted accepting *ijma* and *aql* as separate sources of law, these concepts were eventually adopted by the majority of *Shia* scholars.<sup>48</sup> According to the majority of *Sunnis*, the sources of law are *Quran*, *Sunnah* including the *Hadith* literature, *ijma* and *qiyas* (the juristic inference by

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<sup>44</sup> *Manqul or nass*

<sup>45</sup> *Ma'qul*

<sup>46</sup> See Ali Hasan Abd al-Qadir "Nazaratun A'mmah" (Cairo) p. 120.

<sup>47</sup> See Sayf al-Din Ali al-Amidi 'Al-Ahkam fi Usul al-Ahkam' (Egypt, vol. 1) p.223. At the time of al-Amidi (lived 551-631 Lunar Hijri Calendar), the Shia school was against the concept of *ijma*.

<sup>48</sup> See Muhammad Ja'far Jafari Langroodi 'Maktabhaye Huquqi dar Huquq-e Islam' (Tehran: Ganj-e Danesh, 3<sup>rd</sup> edition) pp. 216-217.

analogy). However, there is a minority of *Sunni* scholars who argue that the *Quran* and *Sunnah* including the *Hadith* literature are the only sources of law in Islam. On the other side, there are groups of scholars from different schools of thought of the *Sunni* school who have argued for more sources of law in Islam including, but not limited to, *ray* (personal opinion), *istihsan* (the juristic approbation to overrule the juristic inference), *istislah* (cost and benefit analysis, to overrule the juristic analogy), *sadd al-dharae* (impeding the preliminary means). The *Shia* school refuses to consider them as separate sources of law in Islam. *Bina' uqala*<sup>49</sup> (a kind of good customary practice) has been introduced as a source of law in Islam by some *Shia* scholars. The following are the differences between *aql* (the personal intelligent inference) and *bina' uqala*: a) *bina' uqala* is a function or performance (i.e., a reality or an act in practice), but *aql* is a logical conclusion<sup>50</sup>; b) *bina' uqala* is dependent on repetition of an act in practice, but *aql* is not dependent on an act practised in reality; c) the adoption of *bina' uqala* is subject to passing the cost and benefit analysis, but the inference of *aql* (intelligent) is an abstract rule<sup>51</sup> and not dependent necessarily on cost and benefit analysis. There are numerous legal fictions<sup>52</sup> that have been developed and are widely used by *Sharia* scholars particularly the Islamic jurists from the *Shia* school of thought. The most well-known one is *istishab* (the presumption of continuity). *Istishab* means the presumption of the persistence/continuance of a fact that was undoubtedly in existence in the past but its existence at present is under doubt.

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<sup>49</sup> The practice and understanding of wise people

<sup>50</sup> It seems that, according to Islam, an Islamic ruling whose illah (underlying logic) is not understandable, its wisdom (hikmah) has to be sought in Maqasid al-Sharia (i.e., Objectives or Purposes of law in Islam).

<sup>51</sup> For example see Iran Civil Code article 194 "the words, signs or other acts that by virtue of which the parties to a transaction make the transaction, must be coordinated so that each party understands and accepts the transaction which the other party intended to make, otherwise the transaction will be null and void".

<sup>52</sup> *Foorud qanooniyyah* or *usul amaliyyah*

Some *Sharia* jurists<sup>53</sup> have criticised the *Shia* school of thought because of their overuse and over-practice of *usul amaliyyah* (legal fictions). Regarding the use of *ijtihad*<sup>54</sup> (the juristic inference), *Sunni* and *Shia* schools of thought have held different views. The *Shia* school believes that *ijtihad* is permitted whenever it is necessary and it never ends, but the *Sunni* school, albeit those *Sunni* jurists who in principle agree with the concept of *ijtihad* at all, believe that the gate of *ijtihad* is closed after the passing of the founders of the Hanafi, Hanbali, Maliki and Shafiee schools of thought.<sup>55</sup> Due to the insufficiency and incomplete responsiveness of the Islamic canonical texts to the ever-changing needs of people and human societies, the majority of Islamic jurists have developed the scope of Islamic law sources over time, through the introduction of new legal concepts in strict conformity to the letter and spirit of *Sharia*. The major legal innovations in this regard are impeding the preliminary means<sup>56</sup>, ever-changeability of *Sharia* rules following new good customary practices<sup>57</sup>, the intelligent judgements<sup>58</sup>, rule of inherency<sup>59</sup>, and judicial precedence<sup>60</sup>. The compilation of good customary practices and also the recognition of the regulations of other nations (bordering on Islamic lands) have largely contributed to the development of Islamic law since the early ages of Islam. These recognised rules and regulations are called

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<sup>53</sup> See Ibn Qayyim al-Jawziyyah (tashih-e Abd al-Rahman al-Wakil) 'E'laam al-Muqe'een' (Egypt, vol. 1, 2<sup>nd</sup> edition) pp. 376-378.

<sup>54</sup> *Ijtihad* means a juristic inference or the interpretation of Islamic canonical texts in the cases of silence, ambiguity, and conflict of *Sharia* rules.

<sup>55</sup> See Muhammad Ja'far Jafari Langroodi 'Maktabhaye Huquqi dar Huquq-e Islam' (Tehran: Ganj-e Danesh, 3<sup>rd</sup> edition) pp. 219-220.

<sup>56</sup> *Sadd al-dhara'e*

<sup>57</sup> *Taghyeer Shar' bi-taba'ee urf*

<sup>58</sup> *Tashree' bi-aql*

<sup>59</sup> *Qa'eeda mulaazima*

<sup>60</sup> *Rawiyye-ye qada'ee*

*ahkam imdaae*<sup>61</sup> (verified rules and regulations) and were largely adopted from Roman law, Iranian (Sassanid) law and Jewish (Talmud) law.<sup>62</sup>

## 2.10 Conclusion

The above key concepts and their implications in *Sharia*<sup>63</sup> help us to see how Islamic law differs from what is understood by modern secular legal systems namely civil law and common law.<sup>64</sup> Given the diversity of opinions on many issues from the viewpoint of different Islamic schools of thought, it can be concluded that *Sharia* or Islamic law is not only unsuitable in its applicability as a governing law but is also problematic and risky in the realm of international business and financial transactions.

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<sup>61</sup> See Mahmoud bin Jafar 'Qawame' al-Fudul' (chap-e sangi) p. 198; Abi Ishaq Ibrahim Gharnati a.k.a. Shaatibi (tashih-e Muhammad Muhyi al-Din Abd al-Hamid) 'Muwafiqat' (Egypt, vol. 2) p. 54; Baqir Bihbahani 'Al-Fawaeed al-Atiq (Damime-ye Fusul)' p. 3; Muhammad Jafar Jafari Langroodi 'Huquq Madani: Sulh wa Rahn' (Ibn Sina, vol. 1, 1<sup>st</sup> edition) pp. 201-202.

<sup>62</sup> Ali Hasan Abd al-Qadir "Nazaratun A'mmah", Cairo, pp. 8-9.

<sup>63</sup> For an interesting contemporary research on the origins and evolution of Sharia see W.B. Hallaq, *The Origins and Evolution of Islamic Law* (Cambridge University Press, 2004).

<sup>64</sup> However, as per Al-Gamal, Islamic jurisprudence is very much like a case law system (casuistry), that is to say built chiefly on analogy to precedents. In cases where no legislative canonical texts or canonised consensus is found, jurists resort to some process of *ijtihad* (juristic inference). See Mahmoud A. El-Gamal 'Islamic Finance: Law, Economics, and Practice' (Cambridge University Press, 2006) pp. 15-20, 27-30. The Islamic term for juristic inference or process is called *ijtihad* i.e. doing one's best (to get the most proper decision). In other words, *ijtihad* is a Sharia expert' reasoning to find appropriate rules for new circumstances within the context of Sharia i.e., Islamic canonical texts.

## **Chapter Three:**

# **Part One of the Second Tier of the Model (1) and An Introduction to the Circulation of Subordinate Wealth including the General Law of Transactions**



### 3.1 The First Part of the Second Tier of the Model (1): The Nature and Distribution of Primary Wealth

Every human being is entitled to enjoy and benefit from natural wealth resources (primary wealth) yet nobody can claim to be the beneficiary of a specific part of the natural wealth until it is distributed among the people. In Islam, it is believed and well-accepted that God owns<sup>1</sup> everything including all the wealth in the world. As per the *Quran*, God has entrusted<sup>2</sup> all things to human beings as a whole<sup>3</sup> because of the sense of responsibility and trustworthiness that mankind possesses compared to other creatures in the world. Therefore, human beings may benefit from all the wealth in the world entrusted to them by God, albeit subject to specific limitations.<sup>4</sup> All human beings have to share the proceeds of natural wealth jointly according to their reasonable and legitimate needs and, regarding some natural resources, in proportion to their contributions such as according to their work efforts. Under certain

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<sup>1</sup> See the Quran (5:120) “to Allah belongs the dominion of the heavens and the earth and all that is in them and He has full power over everything”; the Quran (2:284) “to Allah belongs whatever is in the heavens and the Earth”; the Quran (4:126) “whatever is in the heavens and in the earth belongs to Allah; Allah encompasses everything”; Fakhr al-Din bin Muhammad Tureihi ‘Majma al-Bahrein wa Matla al-Nayyerin’ (vol. 1) p. 108 “the right of dominance belongs only to Allah (God) and his Messenger”; Murtaza Ansari ‘Makasib’ (bi-khatte Zayn al-A’bidin) p.162; Muhammad bin al-Hasan al-Hurr al-Amili ‘Wasaeel al-Shia’ (Tehran: Al-Maktaba al-Islamiyyah, 6<sup>th</sup> edition, 1403 Lunar Hijri Calendar, vol. 6/20) p.364.

<sup>2</sup> See the Quran (33:72) “we offered the trust to the heavens and the earth and the mountains, but they refused to carry it and were afraid of doing so; but man carried it”. Human beings are considered to be the vicereagents of Allah (God) in the Earth. See the Quran (35:39) “It is He Who made you vicereagents in the earth”. See also the Quran (57:7); (10:14); and (6:165).

<sup>3</sup> See the Quran (2:29) “He (God) it is who created for you all that there is on the Earth”. For the interpretation of this hadith and also the interaction of public and private rights see Muhammad Hussein al-Tabatabaee ‘Al-Mizan fi Tafsir al-Quran’ (Beirut: Mu’assasat al-A’lami li al-Matbou’aat, vol. 4/20, 1390 Lunar Hijri Calendar) pp. 170-171.

<sup>4</sup> A social human being, intuitively and instinctively, has an excessive desire to acquire or possess more material wealth than he actually needs or deserves. Due to the greedy and avaricious nature of a social human being, his economic behaviour has to be regulated.

circumstances, people may receive priority to enjoy the proceeds of natural wealth if they make them usable and productive.<sup>5</sup> However, they can never acquire the ownership of these wealth resources (called *raqabat al-maal*) but in fact they remain under the control of the public (as a whole) forever. Some Islamic scholars may limit the ownership of proceeds (raw materials) derived from these original wealth resources to those who have directly contributed their work effort in this regard, e.g., catching fish through fishing in seas, cutting wood from the trees in jungles and the exploration and extraction of oil from oil reservoirs.<sup>6</sup> In other words, they may limit the causes of ownership to only direct contributions of labour and exclude the contributors of tools, machines and capital from taking any ownership right. They

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<sup>5</sup> However, this enjoyment is limited (e.g., limited for the lifetime of human beings and also limited for a legitimate and reasonable enjoyment) and it is not absolute. For more in this regard see Muhammad bin al-Hasan al-Hurr al-Amili 'Wasaeel al-Shia' (Tehran: Al-Maktaba al-Islamiyyah, vol. 13/20, 6<sup>th</sup> edition, 1403 Lunar Hijri Calendar) pp. 356, 360, 363, Hadith numbers 24553, 24566, 24576. See also the Quran (4:5).

<sup>6</sup> "Nobody can own something unless it is acquired as a result of one's effort". See the Quran (53:39-41), (76:22), (21:94), (17:19), (88:9), (18:103-105). See also the Constitution of Iran article 46 "Everyone is the owner of the fruits of his legitimate business and labour ...". For more detail see Muhammad Baqir Sadr 'Iqtisaduna' (Qom: Bustan-e Ketab-e Qom Press, 2003) pp. 549-571. If a person (muwakkil) employs somebody else (wakil) as his agent (on the basis of wakala i.e., agency) in order to acquire raw materials from natural wealth resources, the produced raw materials belong to wakil/agent, who has in fact directly produced them rather than muwakkil. The same rule is applicable in the case of ijara (hiring) contract where an employer (musta'jir) hires a worker (ajir) in order to acquire raw materials from the natural wealth resources. The acquired raw materials would belong to ajir rather than musta'jir. Some Islamic jurists have distinguished these two. They believe in retaining the acquired raw materials by muwakkil (principal) in the case of wakala (agency) arrangement; however, not by musta'jir in the case of ijara (hiring) contract (i.e., it would belong to ajir and not musta'jir). It is not allowed that the musta'jir retains the acquisitions and productions and in return compensates the worker for his services rendered in the production process. See Muhammad Hasan al-Najafi a.k.a al-Muhaqqiq al-Najafi 'Jawaahir al-Kalaam fi Sharh Shara'e al-Islam' (Daar al-Kutub al-Islamiyyah, vol. 26/43, 2<sup>nd</sup> edition, 1362 Solar Hijri Calendar) p. 334; Ali bin Abdulkafi al-Sabki 'Takmilat al-Majmu lisharh al-Muhadhab' (Egypt: Sharkat al-Ulama', vol. 11/18) p.8; Muwaffaq al-Din Abi Muhammad Abdullah bin Ahmad bin Muhammad bin Quda'mat and Shams al-Din Abi al-Faraj Abulrahman bin al-Shaykh Abi Umar Muhammad bin Ahmad bin Quda'mat al-Muqaddasi 'Al-Mughni wa al-Sharh al-Kabir' (Daar al-Kitab al-Arabi, vol. 5/12, 1403 Lunar Hijri Calendar) p. 204; Al-Fadil al-Miqdad bin Abdullah al-Suyuri 'Al-Tanqih al-Raa'e li Mukhtasar al-Shara'e' (Maktabat Ayatullah al-Mar'ashi, vol. 2/4, 1404 Lunar Hijri Calendar) p. 285.

argue that the labour contributors will in return compensate the suppliers of tools, machines, and equipment for their customary rental fees<sup>7</sup> and also repay the exact principal amount of capital providers with no excess (to avoid *riba*). However, as per the implications of the thesis foundational theory, it is fair to say that the ownership of the proceeds<sup>8</sup> has to be shared pro rata among the contributors, no matter in what form the contributions are made.<sup>9</sup> In any case, the acquisition of ownership right in the proceeds has to be of an equal value to the contributions made in deriving the proceeds from the natural wealth resources, and any excess value would go to the public as a whole.

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<sup>7</sup> See Abi al-Qasim Najm al-Din Jafar bin al-Hasan a.k.a al-Muhaqqiq al-Hilli 'Al-Shara'e (a.k.a Shara'e al-Islam)' (Mu'assasa Isma'eeliyan, vol. 2/2, 1408 Lunar Hijri Calendar) p.108; Shams al-Din Sarakhsi 'Al-Mabsoot' (Beirut: Daar al-Ma'rafat, vol. 2/15), p. 346; Abi Mansour al-Hasan bin Yusuf bin al-Mutahhar al-Asadi a.k.a Al-Allama al-Hilli 'Qawa'eed al-Ahkaam' (Manshoorat al-Radi, vol. 1) p. 244.

<sup>8</sup> The owners of the proceeds (assets) retain a right of control over these assets and they may use, dispose, and transact with them as they wish.

<sup>9</sup> Some Fuqaha (Sharia jurists) believe that the only investment contract that is allowed in the production of raw materials is a muzara'a (crop-sharing) contract, and some others have added mudaraba (capital and labour partnership) contract to the legitimate investment contracts in this regard. As per Iran Civil Code article 518 "muzara'a is a contract in virtue of which one of the two parties gives to the other a piece of land for a specified time so that he shall cultivate it and share the proceeds". Some Sharia experts (e.g., Sadr) believe that, although muzara'a does not seem to be contrary to Sharia, it has been ruled out during the passage of time in Islamic history. For this argument, they often refer to the following Hadith attributed to the Prophet Muhammad "everybody who possesses a piece of land has to use it to produce agricultural products, and if he cannot do this he has to then pass it to another farmer to cultivate it for production purposes, and he cannot lease it to another just to earn rental fees". See Murtaza Mutahhari 'Barrasi-ye Ijmaali-ye Mabaani-ye Iqtisad-e Islami' (Hikmat, 1<sup>st</sup> edition, 1403 Lunar Hijri Calendar) pp. 57-58. See also Muhammad bin al-Hasan al-Hurr al-Amili 'Wasaeel al-Shia' (Tehran: Al-Maktaba al-Islamiyyah, vol. 17/20, 6th edition, 1403 Lunar Hijri Calendar) p. 345 Hadith no. 32274 "the land belongs to God and He has endowed it to human beings for their enjoyment. If a possessor of land does not use it for three consecutive years without valid justification, the land is taken from his possession and it passess to others to use it". For somewhat different views regarding the ownership of land see Abi Jafar Muhammad bin Mansour bin Ahmad bin Idris al-Hilli a.k.a Muhammad bin Idris al-Hilli 'Al-Sara'eer' (Mu'assasat al-Nashr al-Islami, vol. 1/3, 2<sup>nd</sup> edition, 1410 Lunar Hijri Calendar) p. 477. See also Al-Muhaqqiq al-Sayyed Muhammad Jawad al-Husseini al-A'mili a.k.a al-Muhaqqiq al-Thani 'Miftaah al-Karamat' (Mu'assasa A'al al-Bayt, vol. 7/10) p.3.

### 3.2 An Introduction to the Creation and Circulation of Subordinate Wealth<sup>10</sup>

Unless it is used or consumed by the owner himself, an asset may be disposed of either for the production of further wealth (i.e., for generating profits), for no profit, or for philanthropic purposes.

Regarding consumption, Islam has prohibited *israf* (exceeding the limits of reasonable and legitimate needs i.e., extravagance) and *tabdhir* (unnecessary and wasteful expenditure or consumption i.e., dissipation).<sup>11</sup> Both *israf* and *tabdhir* refer to quantitative and qualitative aspects of economic life. In economic terms, *israf* refers to over-allocation or over-distribution of wealth and *tabdhir* relates to unnecessary allocation or unnecessary distribution of wealth.

Hoarding and the accumulation (*ihtikar*) of any goods and commodities that fall within the essential consumption needs of people is absolutely forbidden. Rather,

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<sup>10</sup> The notion of wealth is closely connected to the concept of property. Interestingly, it should be noted that in the definition and recognition of wealth/property, the primary property is basically not distinguished from the subordinate property both in western terminology and also in Islamic law. As per Supreme Court of the United States, “the right to exclude others” is “one of the most essential constituents in the bundle of rights that are commonly characterised as property”. See *Kaiser Aetna v. United States*, 444 U.S. 164, 176 (1979) and also subsequent decisions following this approach e.g., *Dolan v. City of Tigard*, 512 U.S. 374, 384 (1994); *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1044 (1992); and *Nollan v. California Coastal Comm’n*, 483 U.S. 825, 831 (1987). However, some scholars argue that the right to exclude others from a valued source i.e., a resource that is scarce relative to the demand for it by human beings is beyond just “one of the most essential” elements of property- it is the “sine qua non” i.e., a necessary and enough condition of identifying the nature and existence of property (and is indeed the border line between “property” and “nonproperty” or “unowned things”). Merrill, however, points out that those who are given the right to exclude others from a valued resource usually also are given other rights regarding the resource e.g., the rights to consume it, to convert it, to transfer it, to devise it or to dispose of it by will, to pledge it as security interest, to subdivide it into smaller interests, and the like. See Thomas W. Merrill ‘Property and the Right to Exclude’ (Nebraska Law Review, Vol. 77, Issue 4, 1998) pp. 730-755.

<sup>11</sup> As per the Quran (7:31): “O Children of Adam! Wear your beautiful apparel at every time ... and eat and drink without going to waste and excess, for Allah does not like the wasters and those who go to excess”. See also Muhammad bin al-Hasan al-Hurr al-Amili ‘Wasaeel al-Shia’ (Tehran: Al-Maktaba al-Islamiyyah, vol. 11/20, 6<sup>th</sup> edition, 1403 Lunar Hijri Calendar) pp. 261, 520.

Islam encourages the people to donate and bestow the excess of their wealth to those who are in need and spend their surplus wealth on social needs, and public welfare.<sup>12</sup> These Islamic rules are very powerful tools for abolishing the social gap between the poor and rich and to provide a balance in society.

Given the social responsibility required of an asset owner, his production and investment activity has to be prioritised and conducted according to the legitimate and essential needs of people in society (not necessarily according to the demand<sup>13</sup> rule and the purchasing power of customers in the market). Any production of goods and also provision of services that is linked to dissipation, profligacy, extravagance, and wasteful behaviour is strongly discouraged and some may argue, possibly prohibited.

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<sup>12</sup> See the Quran (2:219) “they ask what ought we to spend (in the way of Allah)? Say spend whatever you can spare”; the Quran (2:195) “spend your wealth in the Way of Allah and do not cast yourselves into ruin with your own hands. Do all things gracefully, for Allah loves those who do all things with excellence”; the Quran (17:29) “do not keep your hand fastened to your neck nor outspread it, altogether outspread, for you will be left sitting rebuked, destitute”.

According to a Hadith (from the Shia school) reported by Abi Ismaeel and attributed to Imam Baqir “... Imam Baqir asked: do the rich people care for the poor? I said no. Then Imam Baqir said those rich people who do not care for the poor are not from us”. See Muhammad bin al-Hasan al-Hurr al-Amili ‘Wasaeel al-Shia’ (Tehran: Al-Maktaba al-Islamiyyah, vol. 6/20, 6<sup>th</sup> edition, 1403 Lunar Hijri Calendar) p. 299.

Also according to a Hadith attributed to Imam Ali (from the Shia school), the true giving of your wealth in the Way of Allah is that that is made voluntarily before the needy ask your help. If your giving is made after the request of the needy, your spending may be just to avoid disappointment and not made truly from your heart”. See Muhammad bin al-Hasan al-Hurr al-Amili ‘Wasaeel al-Shia’ (Tehran: Al-Maktaba al-Islamiyyah, vol. 6/20, 6<sup>th</sup> edition, 1403 Lunar Hijri Calendar) p. 364.

<sup>13</sup> It is well understood that the market demand usually goes beyond the necessary and legitimate needs of people in society and it is often inflated by way of using some wrongful marketing techniques.

### 3.3 The General Law of Transactions: A Comparative Approach

One way of disposing of an asset is to transact with it.<sup>14</sup> Transactions have historically been a social necessity. People in society are unable to be self-sufficient. To satisfy their different needs, people need to cooperate and help each other. They are neither able to produce all their needs nor to consume all they have produced. The excess of one's own products and the need for the products of others has led people to transact with each other. That is why transactions have always played a very important role in distribution and transfer of products and wealth among the people in society.<sup>15</sup> Historically, an early form of transaction was barter (*mua'wada*). In the very basic form of this transaction, both parties are necessarily producers and consumers at the same time. The transaction is not a way of producing wealth, rather it is a way of transferring wealth or products to those who need them. The invention of money as currency, however, broke the direct relationship between production and the creation of wealth and led to ever-increasing monetised trades and investments in which the creation of new wealth became possible with no need to necessarily produce anything. Unlike the very basic form of barter transactions where production is a precondition to the creation of wealth, money paved a new way to the creation of wealth regardless of a production activity and made the holders of money able to earn an excess income from their capital by way of using some transactional techniques. Prior to the rise of

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<sup>14</sup> See the Quran (4:29) "do not devour one another's possessions/assets/properties wrongfully; rather than that, let there be trading by mutual consent/assent".

<sup>15</sup> Regarding the importance and the definition of trade and traders see Abu al-Hasan Muhammad al-Radi bin al-Hasan al-Musawi (the collection of the sayings of Imam Ali) 'Nahj al-Bala'ghah' (Qom: Daar al-Hijrat) p. 438 al-Risalat no. 53. It seems that, as per the definition of trade and trader that is provided by Imam Ali in Nahj al-Balagha, the underlying rationale for the legitimacy of earning income through trade by traders is that the traders bear actual burdens in the provision and carrying the goods from the suppliers of goods to the customers, who really need the goods for some reasonable and legitimate purposes. It seems in any trade where this underlying rationale is missing, the legitimacy of the trade may be severely criticised according to Sharia.

Islam, a capital holder could earn an income from his capital in one of two ways: by doing a trade and investment, or by lending<sup>16</sup> his capital at interest.<sup>17</sup> The *Quran*<sup>18</sup>, at the time of the rise of Islam<sup>19</sup>, permitted the former transaction but prohibited the latter one for earning excess income. In the early Islamic period, trade and investment were in practise either performed individually or in participatory forms. At an individual level, the most practised form of transaction was *bay* (sale) transaction and the participatory arrangement used in practice was *musharaka*<sup>20</sup> (partnership).

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<sup>16</sup> In lending (loan) transactions, irrespective of the results of trades or investments in which the borrowed capital is spent or consumed, lenders receive an absolute excess on their loans from borrowers (as practiced in the present-day banking and finance world).

<sup>17</sup> See A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A.S. Noordeen, 2005) pp. 51-52.

<sup>18</sup> See the Quran (2:275) "they said, trade is just like riba, whereas Allah has made trade lawful and riba unlawful". From the viewpoint of Sharia, the prohibition of riba does fall within the scope of public law and by no means, it can be circumvented.

<sup>19</sup> For the purpose of fair distribution of wealth and due to the significant role of markets in this regard (as it is understood from a Hadith "the origin of the devastating behaviours go back to markets"), Islam made radical changes in the rules of business and economy. Introducing the rules governing the use of natural wealth resources especially lands and the prohibition of riba were the first two radical changes. However, these rules were ignored by the Arab businessmen and also markets operating in the early Islamic society. See Muhammad Ja'far Jafari Langroodi 'Maktabhaye Huquqi dar Huquq-e Islam' (Tehran: Ganj-e Danesh, 3rd edition) pp. 325-326.

<sup>20</sup> Musharaka is a partnership arrangement between two partners or more to finance and run a business or an investment venture whereby any profit derived from the venture or loss (if any) incurred by the venture will be distributed among the participants. For more on the definition and different types of musharakas written by contemporary scholars see A. L. Udovitch 'Partnership and Profit in Medieval Islam' (Princeton University Press, 1970); I.A.K. Nyazee 'Islamic Law of Business Organization: Partnerships (The Islamic Research Institute Press, 1998); and also M. Siddiqi 'Partnership and Profit-Sharing in Islamic Law' (Islamic Foundation, 1985). Looking at the law of partnerships in Islam makes it clear how there are diverse opinions by different Islamic schools of thought in this regard and how it is important to standardise the law of partnerships in the Islamic business law. This research, having provided a foundational theory, tries to give a new approach with regard to the standardisation of partnerships in the framework of a new intellectual model provided by the thesis. This approach is provided in the discussion on musharakas in the following chapters.

### 3.3.1 The “Promise” Theory vis-à-vis the Theory of “Transfer of Ownership”

In the legal sense, the essence of a transaction or contract is a “promise”. This is the original view of the majority of *Shia* scholars. They argue that no contract is imaginable without carrying a promise.<sup>21</sup> In contrast, the *Sunni* school of thought has not discussed this (promise) theory and instead its scholars have considered “transfer of ownership” as the essence of a transaction or contract. According to this thought, the existence of a tangible asset is required for the validity of a contract (i.e., for the transfer of ownership from the transferor to the transferee). The following are the effects of this idea. The transfer of the ownership of a *ma’dum* i.e., non-existent, contingent or fantasy asset is impossible (according to Hanbali, Shafiee and Hanafi schools)<sup>22</sup>; however, if its existence is subject to another asset which exists in reality then the transfer of ownership of the non-existent asset will be valid due to its subordination and attachment to the asset that is in existence – although there are some *Sunni* scholars who have argued against the validity of this type of transaction as well. As per ibn Taymiyyah,<sup>23</sup> some *Sunni* jurists have argued in favour of voiding transactions of non-existent (*ma’dum*) property/assets. As per this thought/theory, an *ijara* (leasing) contract, whereby the contingent future benefits resulting from the property of the lessor are leased to the lessee, has to be considered basically void. However, some other *Sunni* jurists have argued that it is a valid and legitimate contract

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<sup>21</sup> According to a Hadith recorded by Abdullah bin Sanan “the essence of a contract or transaction is a promise” (al-aqd al-ahd). See Ahmad Naraqi ‘Awa’eed al-Ayyaam’ (chap-e sangi) p. 43; Muhammad Hussein Gharawi Isfahani ‘Hashiye-ye Kumpani a.k.a Hashiye bar Makasib’ pp. 5, 138-139.

In contrast to the Islamic Shia school of thought, the essence of a contract is a bargain (bargained-for legal detriment/benefit) in the common law of contracts in the US.

<sup>22</sup> See Ibn Qayyim al-Jawziyyah (tashih-e Abd al-Rahman al-Wakil) ‘E’laam al-Muqe’een’ (Egypt, vol. 1, 2<sup>nd</sup> edition) p. 347.

<sup>23</sup> See Ibn Taymiyyah ‘Al-Qiyas fi al-Shar’ al-Islami’ (Cairo: Al-Salafiyyah, 2<sup>nd</sup> edition, 1375 Lunar Hijri Calendar) p. 23.



due to the public need (*haajat al-aammah*) rule.<sup>24</sup> It is worth noting that some *Shia* scholars<sup>25</sup> have been influenced by the transfer of ownership theory provided originally by the *Sunni* school of thought.<sup>26</sup> For example, this group of *Shia* scholars have analysed *ijara* (leasing) contracts on the basis of transfer of ownership of the

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<sup>24</sup> See Ibn Taymiyyah 'Al-Qiyas fi al-Shar' al-Islami' (Cairo: Al-Salafiyyah, 2<sup>nd</sup> edition, 1375 Lunar Hijri Calendar) p. 23. Shaatibi, a great Maliki jurist, has treated both promise and transfer of ownership as exact the same concepts, but without mentioning the term promise (*ahd/ta'ahhud*) or any other similar terms such as undertaking (*iltizam*). See Abi Ishaq Ibrahim Gharnati a.k.a. Shaatibi (tashih-e Muhammad Muhyi al-Din Abd al-Hamid) 'Muwafiqat' (Egypt, vol. 3) p. 114.

<sup>25</sup> See Ashrafi 'Sha'aeer al-Islam' (chap-e sangi) p. 277.

<sup>26</sup> Historically, the reaction of Shia scholars to the transfer of ownership (*tamliki*) theory of Sunni school has to be distinguished into two different periods of time: a) in the early stage, they (i.e., Shia jurists) knowingly distinguished the transfer of ownership concept from the concept of promise (*ahdi*) and argued that the promise and transfer of ownership cannot co-exist in a contract. As a result, they declared the sale of non-existent/contingent (*ma'dum*) assets void from the perspective of transfer of ownership theory but valid from the viewpoint of promise theory (e.g., they argued whether the essence of labour/employment contract is in fact transfer of ownership (*tamlik mana'fe*) or promise (*iltizam amal*))- see Zayn al-A'bidin Shahid Thani 'Masalik al-Afham' (chap-e sangi, vol. 2, 1310 Hijri) p. 256; b) in the next stage, they developed the promise theory and then incorporated the transfer of ownership concept into the promise theory (on the basis of categorising contracts into: consensual and promissory). Interestingly, one of the leading Shia jurists has argued that under the concept of transfer of ownership, the existence of the asset (as the subject of ownership) at the time of the execution of the contract is not necessary at all (e.g., as it is the case in the contract of *salam* i.e., commodity based spot payment /deferred delivery contract). In other words, he believes that the purpose of the transfer of ownership is not to deliver the sold asset at the time of the execution of the contract but to make it under the control of the transferee to take it legally in possession. Furthermore, he has pointed out that it is not necessary that the transferor to be in possession of the sold property/asset, at the time of the contract. For example, a worker is not in possession of the labour force he has not yet released to perform a requested work under an employment contract but he can however, make a promise in favour of his employer to transfer the benefits of his labour force for a specific period of time in the future. As per this interpretation by some Shia scholars, unlike the Sunni school, the sale of non-existent assets at the time of a contract can be a valid transaction under certain conditions - see Muhammad Kazim Tabatabaee (bi-khate Zayn al-A'bidin) 'Hashiye bar Makasib' (chap-e sangi, 1326 Lunar Hijri Calendar) pp. 25, 52, 58. It should be noted that as per this view by Kazim Tabataba'ee, in a contract, the transfer of ownership is considered a necessary consequence (effect) of the promise. Looking at the historical roots of promise theory, some may argue that the roots of the promise theory in Civil Law as it is understood today refers to the above mentioned promise theory introduced originally by the Shia school of thought (but with one big difference: the focus of the promise theory of the Shia school is on the positive aspects of promise i.e., claims/rights of the transferee unlike the Roman law where the focus is on the negative aspects of the promise i.e., debt/obligations of the transferor).

usufructs of the property, which is leased under an *ijara* contract. Some others<sup>27</sup> have criticised the sale of non-existent assets (similar to the Hanbali, Shafiee, and Hanafi schools), however, they have argued for the sale of, for example, the fruits of trees - though they are contingent and not-yet-realised assets. Furthermore, following the transfer of ownership theory of the *Sunni* school, some *Shia* scholars have divided transactions/contracts (e.g., wills<sup>28</sup>) into two categories: promissory (*ahdi*) and transfer of ownership (*tamliki*). Some *Shia* scholars<sup>29</sup> have criticised this approach and believe that this distinction is not a true idea according to the original thought of the *Shia* school in this regard (i.e., *al-aqd al-ahd*). They have, however, argued for another categorisation of the contracts: consensual (*idhni*) and promissory (*ahdi*). The former category contracts are dependent solely on the consent and permission of the owner or possessor of the asset and it is not binding on the parties (e.g., *wadi'a*<sup>30</sup> and *a'riya*<sup>31</sup>) but the latter category contracts depend on the mutual promise/assent of the transferor and the transferee (e.g., *bay'*,<sup>32</sup> *ijara*,<sup>33</sup> and *hiba*<sup>34</sup>).<sup>35</sup> As it has become clear, the adoption of the transfer of ownership theory may largely limit and affect the scope of contemporary Islamic business and financial transactions, while, in contrast, the application of promise theory may significantly expand the scope of Islamic business

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<sup>27</sup> See Ashrafi 'Sha'aeer al-Islam' (chap-e sangi) p. 385.

<sup>28</sup> According to Iran Civil Code article 825 "Wills (*wasiyyat*) are divided into two categories: promissory and transfer of ownership".

<sup>29</sup> See Muhammad Ja'far Jafari Langroodi 'Maktabhaye Huquqi dar Huqug-e Islam' (Tehran: Ganj-e Danesh, 3<sup>rd</sup> edition) pp. 204-205.

<sup>30</sup> Safe-keeping deposit

<sup>31</sup> Use-free contract

<sup>32</sup> Sale

<sup>33</sup> leasing

<sup>34</sup> Voluntary gift

<sup>35</sup> Surprisingly, Iran Civil Code (which is dominated by the *Shia* school of thought) in articles 338, 466 and 795 categorise these latter contracts i.e., *bay*, *ijara*, and *hiba* under the transfer of ownership (*tamliki*) contracts (similar to the *Sunni* school of thought) rather than promissory (*ahdi*) contracts.

and finance. Following the transfer of ownership theory, its advocates<sup>36</sup> argue that a seller cannot transact on an asset until he takes it in his possession and owns it in the first place.<sup>37</sup> As per these scholars, an object must be in existence in order to be capable of being transacted. However, it seems, to be transactionable, the cause of an asset has to be in existence at the time of the contract but not necessarily the asset itself. If the prospective asset is reasonably within the control of the transferor and seller at the time of the contract, and it is capable of being described sufficiently in terms of quantity and quality at the time of transaction, it is promissable to exchange or sell it.<sup>38</sup> For example, in employment contracts and also in forward contracts, it is likely and reasonable that the employee and also the seller will be able to undertake work or acquire the object of sale respectively.<sup>39</sup> In other words, the cause of these undertakings is in existence at the time of the transaction; the realisation of which are reasonably under the control of the employee or forward seller at the time of the contract; and they are capable of being described in terms of quantity and quality at the time of contract. However, the reasonableness condition might no longer exist in further transactions on (i.e., the assignments of) the previously exchanged prospective asset until after it rests and comes into existence under the first transaction. It is worth

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<sup>36</sup> For example, as per Taqi Usmani, in a sale contract, the commodity has to be under the ownership of the seller (i.e., seller should have physical or constructive possession over the asset that is subject to sale) at the time of sale contract, because short selling in which a person sells an asset before he takes ownership of the asset is not permitted in Islamic law. He believes that forward sales are not permitted with the exception of salam and istisna contracts (these contracts will be dealt with in a great detail later). See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) p. 148.

<sup>37</sup> They refer largely to this hadith "do not sell an asset which is not with you" (la-tabi-maa-laysa-laka-indak).

<sup>38</sup> This shows how it can affect the business and financial transactions and consequently the circulation of wealth if there is a choice to select the promise theory or instead the transfer of ownership theory.

<sup>39</sup> However, it should be noted that the obligee would be unable to resell or exchange the receivable asset until after it came into existence and was ready for full possession by the obligee.

noting that in cases where the prospective asset is a debt receivable<sup>40</sup> (which it is often documented as one in a certificate e.g., a bond certificate) and the creditor wants to assign or sell it with an increase or a decrease, as happens nowadays in the bills of exchange or letters of credit, it is not allowed in *Sharia*.<sup>41</sup> This ruling is in fact a logical consequence of the *riba* prohibition in Islam. The exchange or assignment of debt which only represents a monetary liquid asset is possible only if it is exchanged for the same amount of money at its par value. However, unlike the debt receivable, an equity receivable which is often documented in a certificate<sup>42</sup> representing a proportionate share in the total assets of a collective scheme such as investment portfolio, fund, partnership, or company, can be traded free from the mentioned constraints. Neither is it problematic if the total assets of the collective scheme consist of both liquid (monetary) and illiquid (non-monetary) assets.<sup>43</sup>

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<sup>40</sup> It does not matter whether the origin of debt is contract, or tort, or something else.

<sup>41</sup> The Islamic Fiqh Academy of Jeddah, which is the largest representative body of the Sharia jurists from all the Muslim countries, has confirmed the prohibition of bay dayn unanimously without a single opponent. For more on bay dayn see Nasser Katouzian 'Huquq Madani: Darshayi az Uqud Mu'ayyan' (Tehran: Ganj-e Danesh Publication, vol. 1, 2008) p.80; Mohammad Reza Azizullahi 'Qarardad-e Bay'-e Mutaqabil (in Qarardadhaye Tijari Beynal Milali eds' (Qom: Zeitoon Publication, Fasl Nameye Elmi Takhassosi-ye Ulum Insani-Ijtima'ee, vol. 44. 1384 Solar Hijri Calendar) p.30. As per these Islamic scholars, it is certain to say that the sale of a debt receivable in exchange of new debt with extra cost and an extended period of time is *riba* and it is null and void.

<sup>42</sup> Different names may be given to these certificates such as "share", "unit", "sukuk", and any other similar name.

<sup>43</sup> The threshold proportion of illiquid assets represented by the certificate or security (i.e., sukuk) for warranting the negotiability of the certificate has been hotly debated. Some Islamic jurists argue that the ratio of illiquid assets has to be at least 51%, because they believe that if this ratio is less than 50%, then, all the assets have to be treated as liquid for the purposes of negotiability on the basis of the juristic rule, which submits that "the majority deserves to be treated as the whole of a thing". Some other jurists argue for at least 33% ratio in this regard. And as per the Hanafi school of thought whenever the underlying asset is the combination of both illiquid and liquid assets, the certificate is negotiable regardless of the ratio of the liquid portion in the entire asset provided that the illiquid part of the underlying asset must be a considerable proportion, and the exchange value of the combination (i.e., the consideration, which has to be in return paid) must be more than (i.e., neither less nor equal to) the value of the liquid amount contained therein. For more in this regard see Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) p.141.

Comparing to the theories of promise and the transfer of ownership in Islamic law, in common law, especially in the US and UK, the essence of contract is considered to be consideration or bargained-for promise and it is not possible to have a contract without consideration. On this basis, in a bilateral contract, the contract arises when the counter promise is given. As per Ashley, unlike the view of some other scholars, if this counter promise is not the consideration, but its performance is i.e., in a unilateral contract, then the contract arises before the promised performance i.e., before consideration is furnished. In other words, in either event, the contract comes into existence upon acceptance of the offered promise and it is not delayed until performance/consideration is furnished.<sup>44</sup>

### **3.3.2 Nominate Contracts (*Uqud Mu'ayyan*)**

The majority of Islamic *Shia* scholars (unlike the *Sunni* scholars whose majority argue for a close system in contracts) believe that the legitimate contractual forms in Islam are not limited to those specific contracts (*uqud mu'ayyan*) introduced in the early Islamic period,<sup>45</sup> and new transactional forms can be made under the terms of

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<sup>44</sup> See Clarence D Ashley 'Doctrine of Consideration' (Harvard Law Review, Vol. 26, Issue 5, 1912-1913) p. 430.

<sup>45</sup> Some Western scholars think that the law of contracts in Islam is a closed system similar to that of Roman law where there is a list of specific contracts. See Nicholas H. D. Foster 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law' (European Business Organization Law Review, vol. 11, issue 1, 2010) p.10. However, although this thought is also advocated by some other Islamic jurists, it seems to me that the law of contracts in Islam is open and there is a general law of contract in Islamic law (for supporting this claim see the discussions about the theory of "promise" and also the freedom of contract provided before, and also Iran Civil Code articles 10, 183-230).

*sulh*<sup>46</sup> (compromise/settlement) facility if they are necessary to fulfill the necessary needs of humanity.<sup>47</sup> For example, two or more of the Islamic specific contracts can be combined in order to create new contractual products. However, to conduct a legitimate hybridisation initiative, the combined concepts or tools must not have inherent conflicts and contradictions, and also the aim and final hybrid product must be legitimate and consistent with *Sharia*.<sup>48</sup> In contrast, the *Sunni* school has limited the scope of *sulh* to the realm of settlement of disputes, and excludes the possibility of making any contract and transaction under the terms of *sulh*. The *Sunni* school, however, has eventually used a different basis to cover any new necessary transaction, with its own terms and conditions, according to the concept of *nadhr*<sup>49</sup> (vow or oblation) instead of *sulh*.

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<sup>46</sup> As per Iran Civil Code article 752 “sulh (settlement) can be made either in the case of the adjustment of an existing dispute, or for avoidance of a potential dispute in the case of a transaction and the like”. As per article 758 “any sulh whose result is equivalent of the content of a specific contract/transaction, will not be governed by the specific terms and conditions relating to that specific contract; but rather, the terms and conditions of sulh will be applied in this regard. Therefore, for instance, if the subject of sulh is a definite object given in return for a consideration, its results will be equivalent to a sale, but the special conditions and rules appertaining to the sale will not be applied”. For the legitimacy and the importance of sulh in the Hadith literature and also for some other supporting evidence in this regard see Abi al-Hasan Ali bin Khalil Turabli ‘Mu’een al-Ahkaam’ p. 153; Muhammad Jafar Jafari Langroodi ‘Huquq Madani: Sulh wa Rahn’ (Ibn Sina, vol. 1, 1<sup>st</sup> edition) pp. 139-140.

<sup>47</sup> That is why sulh is called the father of contracts (sayyed al-uqud) and the father of rules (sayyed al-ahkaam) in the Islamic Shia School of thought.

<sup>48</sup> As per Thomas, the majority of Islamic schools of thought do not allow combining contracts. See Abdulkader Thomas ‘Methods of Islamic Home Finance in the United States- beneficial breakthroughs’ (The American Journal of Islamic Finance, 2001) p.2. For example, as per Thomas, it is not allowed to integrate a lease contract into a contract of sale.

<sup>49</sup> To see the concept of nadhr in the Quran see (2:270): “Surely Allah knows ... whatever vow you may have made, and the wrong-doers shall have no helpers”. It is the concept of “nadhr tabarrur” that has been used by the Sunni school of thought to justify the legitimacy of any necessary new transaction. Nadhr tabarrur means making a vow voluntarily without the expectation of any award in return from Allah (God). If it is made for the expectation of an award from Allah (God), it is called “nadhr mujazaat”. It seems nadhr cannot be a proper basis for the mentioned purpose because nadhr is made unilaterally while a transaction/contract is a kind of mutual arrangement and requires at least two wills to conclude. See Muhammad Jafar Jafari Langroodi ‘Huquq Madani: Sulh wa Rahn’ (Ibn Sina, vol. 1, 1<sup>st</sup> edition) p. 145; and Allameh Hilli ‘Tadhkirat al-Fuqahaa’ (chap-e sangi-ye marghub) p. 758.

### 3.3.3 Form versus Substance

The last general point about transactions is the issue of form versus substance. It is not enough that the mere form of a transaction (any product or institution) is within the framework of Sharia. To be valid, the substance of the instrument or institution also has to be in accordance with the rules and objectives of *Sharia*<sup>50</sup>. In other words, the consequential outcome of a transaction as well as its structural form must meet the rules and objectives of *Sharia*. A for-profit transaction must include, at least partially, a non-monetary asset,<sup>51</sup> and the function and also the aim of the institution must match the objectives of *Sharia*.<sup>52</sup> Two different transactions may have similar substance (i.e., the consequential outcome) but one may be considered valid and the other invalid. This is because the instrumentality or form which is used to achieve a legitimate outcome must also be legitimate from the viewpoint of *Sharia*. For example, an installment contract to sell goods is allowed, but one to sell money or credit is not permissible. Both transactions are very similar in substance to a loan but they are in

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<sup>50</sup> In other words, substance is determined by the Maqasid al-Sharia.

<sup>51</sup> The reason for this is that a (for-profit) financial transaction involving monetary assets in both sides of the exchange is not a valid sale contract but it is *riba*. For supporting evidence in this regard see the Quran (2:275): “they said that sale is like *riba*; but, they do not understand that (they are different and), God has allowed the sale but prohibited *riba*”.

<sup>52</sup> As per the Quran (2:177) “true piety does not consist in turning your faces towards the east or the west ... but truly pious is he who believes in God, and the Last Day, and the angels, and revelation, and the prophets, and spends his wealth - however much he himself may cherish it- upon his near of kin, and the orphans, and the needy, and the wayfarer, and the beggars, and for the freeing of human beings from bondage ... and renders the purifying dues; and truly pious are they who keep their promises whenever they promise”. Piety (*birr/taqwa*) is that obedience to God which is well established in the heart, or as the sum of acts of obedience and devotion conducting one closer to God, as similar to such acts when one speaks of filial piety.

distinct forms.<sup>53</sup> As another example, consider a prospective buyer who wants to buy a house. Owning the house is considered the outcome or substance of the transaction and how to achieve this outcome is considered to be the form or instrumentality of the transaction. The conventional way for the prospective buyer to buy the house is to get a loan from a bank and repay the loan with additional interest. Obviously, the loan transaction, which is a for-profit financial transaction and involves monetary assets in both sides of it (getting the loan in return for repaying the loan with some additions) is *riba* and prohibited according to *Sharia*. In other words, though the substance/outcome of the transaction i.e., owning the house is legitimate, the form/instrumentality i.e., loan structure used to achieve the outcome is illegitimate. A true Islamic way to achieve the same outcome/substance would be by way of using *murabaha* (cost-plus sale) facility, which is a type of sale contract. According to the *murabaha* structure, a financier buys the house from the seller and then resells it to the prospective buyer in installments with some profit. In this example, the form/instrumentality that is used to achieve the aim is a legitimate *murabaha* structure. This structure involves the exchange of a non-monetary asset (house) with a monetary asset (installment payments) and hence it is not considered to be *riba* from a *Sharia* viewpoint.<sup>54</sup>

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<sup>53</sup> See Abdulkader Thomas 'Methods of Islamic Home Finance in the United States- beneficial breakthroughs' (The American Journal of Islamic Finance, 2001) p. 2.

However, it should be noted that the contemporary *murabaha*, in the case of a mortgage, functions like a conventional secured loan. Worse is that the contemporary *murabahas* in the case of a mortgage are not, not only true Islamic *murabahas* (i.e., types of sales contracts), they are often more expensive as they impose further costs from the extra administrative expenses, and usually have less legal protections than the conventional mortgages. See Caner K. Dagli 'Islamic Law, Shariah-based Finance, and Economics' (College of the Holy Cross, Pre-publication draft) pp. 12-13.

<sup>54</sup> Some scholars argue that the *murabaha* structure, if examined very carefully, is in essence functionally equivalent to modern mortgage structures, involving almost identical allocations of risk and capital. See Caner K. Dagli 'Islamic Law, Shariah-based Finance, and Economics' (College of the Holy Cross, Pre-publication draft) pp. 9-10.



A very recently developed financial trick in the modern *Sharia*-compliant banking and finance industry is the “*Sharia* conversion” technique. According to this trick, a two-tier deal arrangement is made between the Islamic financial institution and the Islamic investor: the outer level arrangement which is a *Sharia* compliant transaction and the inner level arrangement which is usually not *Sharia* compliant investment. The Islamic financial institution buys the commodity (which normally has been acquired immediately before by the Islamic investor from the market) from the Islamic investor on a deferred payment basis with a mark-up which is usually benchmarked to the prevalent rate of interest in the monetary market and then the bank immediately sells the exact same commodity in the market to use the acquired cash in its intended profit-making investments. Simultaneously, the Islamic bank makes a promise (*wa’d*) to the Islamic investor to swap the returns of the investor from the outer level transaction (i.e., the mark-up) with the returns arising out of the inner level transaction/investment, which is not necessarily *Sharia* compliant.<sup>55</sup> The reason for the promise to swap is that there is a strong presumption that the non-*Sharia* compliant inner level investment will outperform the *Sharia* compliant outer level transaction.<sup>56</sup> It is obvious that the *Sharia* conversion technique is a trick to circumvent the application of *Sharia* rules and objectives as to the substance of the transaction. As said before, to be Islamic, the given transaction not only has to fall within the

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<sup>55</sup> For example, the bank may invest the money in buying bonds which are not *Sharia* compliant.

<sup>56</sup> For more in this regard see Yusuf Talal DeLorenzo ‘The Total Returns Swap and the *Sharia* Conversion Technology’ Available via the Internet at <http://www.dinarstandard.com/finance/DeLorenzo012308.htm>

requirements of *Sharia* in its structural form, but also in its substantive outcome.<sup>57</sup> In the case of any conflict, the substance requirement prevails over the form. The reason is simple: purpose matters more than form.

According to Dagli, it is not true to say that there could not be “substance-over-form” successful practices, which comply with both the spirit/substance and letter/form of *Sharia*. For example, there could be mutual savings schemes<sup>58</sup> running in accordance with both the spirit and letter of *Sharia* where the profits belong to the depositors and also mutual insurance plans in which the participants have no incentives for earning interest.

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<sup>57</sup> As per Asutay, an important part of the social failure of contemporary Islamic banking and financial institutions is ignoring the “substance” and instead giving priority to the “form”. As per him, in the form-oriented approach the focus is made on the structure of a product, while the emphasis of substance is on the consequences and outcome of the product. To support his argument, he refers to Ibn Qayyim’s opinion stated centuries ago, when he warned of the detrimental harm of alternative *riba*-free products if the true substantive and moral objectives were overlooked in the alternative products. See Mehmet Asutay ‘Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs. the Realities of Islamic Finance’ (Asian and African Area Studies, vol. 11, issue 2, 2012) pp. 107-108

<sup>58</sup> The very purpose of the mutual savings scheme is to make conservative investments. Seeking greater returns is only subject to taking greater risk, which is essentially in contradiction of the very purpose of the mutual savings scheme in the first place. It was perverse incentives for making greater interest and profits which, to a large extent, drove the financial institutions as well as markets to collapse in 2008. See Caner K. Dagli ‘Islamic Law, Shariah-based Finance, and Economics’ (College of the Holy Cross, Pre-publication draft) pp. 12-13.

## **Chapter Four:**

# **Part Two of the Second Tier of the Model (2): For-Profit Products and Collective Schemes**

## 4.1 Introduction

The economic needs of humanity, whether they are for the supply of or demand for assets, have to be fulfilled insofar as they are reasonable and legitimate and contribute to achieving social justice.

Economic rights are essential to the maintenance of basic human and civil rights. They are recognised by economic rights conventions such as the International Covenant on Economic, Social, and Cultural Rights (ICESCR). As per Khan<sup>1</sup>, the first thought of economic rights in global thinking context was given by President Franklin D. Roosevelt. He considered economic rights to be as the “freedom from want”: “[t]he right to a useful remunerative job... [t]he right to earn enough to provide adequate food and clothing and recreation... [t]he right of every family to a decent home... [t]he right to adequate medical care... [t]he right to adequate protection from the economic fears of old age, sickness, accident, and unemployment; [and] the right to a good education.”<sup>2</sup> The ICESCR developed these ideas to include “economic self-determination”, “favorable working conditions”, and the “right to a trade union”.<sup>3</sup>

A need is not recognised based only on its apparent current need in the society unless it meets social justice criteria.<sup>4</sup> On the basis of this view, as long as the current customary practices do not violate the implications of social justice they will be recognised and enforced by the economic system.

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<sup>1</sup> See Zeshan Khan ‘International Economic Rights’ (Gonzaga Journal of International Law, Vol. 4) pp. 2 and 4-5.

<sup>2</sup> See Eleventh Annual Message to Congress (Jan. 11, 1944) in 3 The State Of The Union Messages Of The Presidents, 1790-1966, 2875, 2881 (Fred L. Israel ed., 1966)

<sup>3</sup> See ICESCR, Jan. 3, 1976, 993 U.N.T.S. 3. See also G. A. Res. 2200, UN GAOR, 21st Sess., Supp. No. 16, at 49, UN Doc. A/6316 (1976) (UN Resolution adopting the Covenant); also see Articles 7 and 8.

<sup>4</sup> For a similar approach taken by the great Islamic scholar al-Ghazali in this regard see (cited by) Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 277.

A given supply of or demand for an asset may be made either for profit, to be profit-free or for a philanthropic purpose, regardless of whether it is supplied or demanded by individuals, businesses, not-for-profit organisations, state-run entities or governments. In order to offer products and services to fulfil needs, the major issue is whether or not and to what extent the offered product or service reflects the balance of interests and risk among the different participants and also reflects the themes of ethical investment, benevolence, fairness, and social justice.<sup>5</sup>

This chapter deals with the different facilities and techniques to cater for the recognised profit-making purposes in their different manifestations, to be followed by profit-free, benevolent and microbusiness tools and institutions in the following chapters.

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<sup>5</sup> The major facilities and their main characteristics will be covered in this thesis; however, explaining all the varieties of products and services is beyond the confines of the thesis.

## 4.2 Products and Collective Schemes

Inspired by Islamic business and financial law, the following are the main legal products and facilities to respond to the necessary and legitimate needs in different circumstances for basic profit-making purposes.<sup>6</sup>

### 4.2.1 Sale (*Bay*)

*Bay*<sup>7</sup> is an agreement between two parties whereby one of the parties transfers the ownership of some specified assets in return for a known consideration by the other party. Essential elements to a valid sale contract in *Sharia* are: mutual assent that has been verbalized between the parties; an asset (the object of the sale); and an offer and an acceptance. The essential 'external' conditions to a valid sale contract in *Sharia* are: adulthood, sanity and discernment of the parties; correlation between the offer and acceptance and immediate agreement; unity of the contract session; the asset should be owned by the seller, be saleable, and also deliverable; and the price<sup>8</sup> as well as the asset should be clearly described. A *bay* contract may be used for trade and exchange purposes.

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<sup>6</sup> It should be noted that some of the following products may also be used in a not-for-profit context. Although this is the case, they are often used in a profit-making context. That is why they are dealt with in this part.

<sup>7</sup> See Iran Civil Code articles 338-395.

<sup>8</sup> The price must be certain and known to both parties. Any price which is not fixed or is linked to an uncertain event would render the bay contract void.

#### 4.2.2 Exchange of Gold and Silver (*Sarf*)

*Sarf* (exchange of gold and silver) is a type of *bay* contract for buying and selling gold or silver assets whether they are coined or not coined.<sup>9</sup> The opinions of Islamic scholars are divided as to whether this facility can be used for the exchange of foreign currencies with each other and also the exchange of gold or silver with a currency (especially if the value of the currency is not linked to gold or silver). To be a valid *sarf* contract, most Islamic scholars<sup>10</sup> (in contrast to a minority group of scholars<sup>11</sup>) believe that the delivery of the subject matter of a *sarf* contract must happen at the time of the *sarf* contract; otherwise it would be null and void.

#### 4.2.3 Forward Contract (*Salam*)

*Salam* (forward) is another type of *bay* (sale) contract according to *Sharia*. *Salam* is in fact a prepaid forward contract that was initially practised prior to the advent of Islam for the sale of agricultural crops. This contract was recognised and legitimised by the Prophet Muhammad subject to minimal regulation ordering that the buyer and seller have to specify the sale asset, delivery time and price in each case as precisely as possible. This facility may be used to finance agriculture, livestock, and production activities.

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<sup>9</sup> See Abulqasim Najm al-Din Jafar bin Hasan Hilli a.k.a. Muhaqqeq Hilli 'Sharaye al-Ahkam: Kitab al-Matajir-Bay' (chap-e sangi, Ofset Kitabchi); Shahid Thani 'Sharh Lum'a' (vol. 2) p.374; and Shahid Thani 'Masalik al-Afham: Sharh bar Sharaye Muhaqqiq' (vol.1/2), p. 201.

<sup>10</sup> See Hasan Imami 'Huquq Madani' (Tehran: Islamiyya, vol. 1, 4<sup>th</sup> edition, 1352 Solar Hijri Calendar) p.447 and also Muhammad Ja'far Ja'fari Langhroudi 'Da'eerat al-Ma'arif Huquq' (vol.1) p.574.

<sup>11</sup> See Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan' (Tehran: Sahami Intishar, vol.1, 10<sup>th</sup> Edition) pp. 162-163. Katouzian argues for the validity of a *sarf mu'ajjal* contract in which a specific time in the future may be agreed for the delivery of the subject matter (gold or silver) of the contract. However, in this case he believes that the transfer of ownership will happen at the time of delivery and not the time of the *sarf* contract. For this reasoning, he invokes the Iran Civil Code article 364.

#### 4.2.4 Sale-with-Repurchase-Option (*Bay Shart*)

*Bay shart* or *bay wafa* (sale-with-a-repurchase-option) is another type of *bay* contract in which the transacting parties stipulate that should ever the seller, within a specified period, give back to the purchaser the whole of the equivalent of the consideration, the seller may exercise his option of cancelling the transaction in regard to the whole of the asset. Similarly, they may stipulate that if ever the seller gives back a portion of the equivalent of the consideration, the seller may also exercise the option of cancelling the transaction in regard to all or part of the asset. In any case, the scope of the option depends on the mutual agreement of the parties and if there is no special mention of whether the whole or whether a part of the consideration has to be returned, the option will not be effected unless the whole of the equivalent of the price is returned.<sup>12</sup> In *bay al-shart*, upon the execution of the contract, the purchaser obtains the ownership of the asset. All the benefits pertaining to or arising out of the asset (up until the exercise of the option by the seller) belong to the purchaser and he may lease it out and earn income (rental fees) up until the exercise of the repurchase-option by the seller.<sup>13</sup> This facility may be used for liquidity purposes.

#### 4.2.5 Deferred Payment Sale (*Bay Nasiya*)

*Bay nasiya*<sup>14</sup> is another type of *bay* contract in which the payment of the sale price is deferred but the delivery of the asset is immediate. This type of sale contract is

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<sup>12</sup> See Iran Civil Code article 458. See also Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 334-336, articles 458-463.

<sup>13</sup> See Iran Civil Code article 500.

<sup>14</sup> This is also called *bay bi-thaman mu'ajjal*.



different from *murabaha* (cost plus mark-up sale) contract. In the latter, the original cost of the asset has to be disclosed to the buyer upon the execution of the contract.<sup>15</sup>

#### 4.2.6 Cost plus Mark-up Sale (*Murabaha*)

*Murabaha* is also another type of *bay* contract whereby a vendor resells an asset<sup>16</sup> to the purchaser with a mutually agreed addition (also called mark-up)<sup>17</sup> to the original cost paid to a third party supplier to acquire the asset in the first place. The mark-up may be either in a form of a percentage of the original cost of the asset or a lump sum amount.<sup>18</sup> The original cost of the asset must be precisely disclosed to the purchaser before the execution of the *murabaha* contract. That is why bargaining over the original cost of the asset in a *murabaha* contract is not allowed. The vendor may resell the asset for immediate cash<sup>19</sup> or on a deferred payment basis<sup>20</sup> i.e., on a credit basis. In the latter case, the vendor may ask for some assurance from the purchaser for the payment of the purchase price. *Murabaha* may be used in financing the acquisition of necessary goods whether it is for essential consumption needs or for construction and production purposes. It may also be used for microfinance purposes. The latest

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<sup>15</sup> See Zamir Iqbal and Abbas Mirakhor 'An Introduction to Islamic Finance: Theory and Practice' (Wiley, 2<sup>nd</sup> edition, 2011) p. 91.

<sup>16</sup> The asset (object) must have been acquired by the vendor from a party other than the purchaser.

<sup>17</sup> Taqi Usmani has issued a fatwa that this mark-up can be benchmarked to a conventional interest rate. See Mahmoud A. El-Gamal 'Islamic Finance: Law, Economics and Practice' (Cambridge: Cambridge University Press, 2007, reprint) p.67. El-Gamal, however, does not mention a valid source of this fatwa/ruling by Taqi Usmani. This should be of concern because when it comes to sukuk, Taqi Usmani has clearly rejected the benchmarking of the expected rate of return to the prevalent rate of interest.

<sup>18</sup> For a similar definition see Adnan Bulent Baloglu 'Law of Sales in the Works of Marwazi, Quduri, and Sarakhsi' (University of Manchester PhD Thesis, 1991) pp.78, 83, 86. Baloglu argues that, as per Qudri who bases his reasoning on the Sunnah of the Prophet Muhammad, especially the issue of gharar in Sharia, the vendor is not permitted to resell the moveable object (unlike the immoveable object which is permitted as per both Abu Hanifa and Abu Yusuf due to the much lower risk of loss of the immovable object) to the new purchaser prior to the complete possession (whether it be actual or constructive possession) of the object bought from the third party supplier.

<sup>19</sup> *Thaman hall*

<sup>20</sup> *Thaman mu'ajjal*

developed derivative of *murabaha* is commodity *murabaha* or organised *tawarruq*, which has been justly criticised by the Mecca *Fiqh* Academy. Commodity *murabaha* is grounded on commodities which are traded on the London Metal Exchange (LME).<sup>21</sup> As per this type of *murabaha*, party A, who is facing a liquidity concern approaches party B, who furnishes a commodity on spot price and sells the commodity to party A with a mark-up on a deferred payment basis. Thereafter, party A sells the purchased commodity to a third party, or possibly back to party B, on a cash basis in order to acquire the needed liquidity. It is due to the first part of the transaction that it is called commodity *murabaha* and it is for the second part of the transaction that it is labelled organised *murabaha*. As can be seen, both these concepts are combined in the same transaction.<sup>22</sup> Although *tawarruq* masquerades as a sale contract, it is in fact a loan contract benchmarked to the prevalent market interest rate.<sup>23</sup> The *Fiqh* Academy of the Organization of the Islamic Conference (OIC) in Jeddah ruled *tawarruq* illegitimate in its session in December 2003 as it stands, in its current use in the modern Islamic finance industry.<sup>24</sup> Following the form versus substance rule discussed earlier, the purpose of the organised *tawarruq* is the same as a loan with interest and hence it has to be treated as an illegitimate transaction. As said before, purpose or substance matters more than form.

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<sup>21</sup> In Malaysia, the underlying commodity which is used as the basis of commodity *murabaha* is crude palm oil. The commodity *murabaha* in Malaysia gained the official endorsement of the Sharia Advisory Council of the Central Bank of Malaysia on 28 July 2005. See Asyraf Wajdi Dato Dusuki 'Islamic Finance: An Old Skeleton in a Modern Dress' (Kuala Lumpur: ISRA/INCEIF, 2008) p. 228.

<sup>22</sup> For the definition and applications of organised (munazzam) *tawarruq* see AAOIFI Sharia Standard No. 30.

<sup>23</sup> See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 242.

<sup>24</sup> For details in this regard see Mahmoud A. El-Gamal 'Islamic Finance: Law, Economics and Practice' (Cambridge: Cambridge University Press, 2007, reprint) p. 72.

#### **4.2.7 Sale-Repurchase of the Same Asset (*Bay Ina*)**

*Bay ina* is another type of *bay* contract in which the same commodity is sold to a customer on a credit price and bought back from the customer in cash at a price lower than its credit price in order to finance the customer. Clearly, such a sale contract disguises *riba* and if it does not violate the ‘letter’ of *Sharia*, it likely violates the ‘spirit’ of *Sharia*. This was explained before, in case of conflict the ‘purpose’ or ‘substance’ of the transaction prevails over the ‘form’ of the transaction.<sup>25</sup>

#### **4.2.8 Construction Finance (*Istisna*)**

*Istisna* is a purchase order contract of goods whereby a purchaser places an order to buy goods that will be manufactured and delivered in the future, that is to say, a purchaser will ask a manufacturer to construct and deliver the goods that will be made in the future in accordance with the specifications agreed in the purchase order. The parties to the contract will mutually agree on the purchase price as they intend and the payment of price can be delayed or arranged according to the schedule of the work progress. This facility may be used in construction and project finance.<sup>26</sup>

#### **4.2.9 Purchase Option (*Bay Urbun*)**

*Bay urbun*<sup>27</sup> is a purchase option whereby a person who wants to purchase a commodity in the future, will pay part of the known price at the inception of the contract and the remaining at the time of settlement when he purchases the agreed asset. If he fails to purchase the asset, the prepayment will be forfeited. It is said that

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<sup>25</sup> For a similar argument see Bank Negara Malaysia ‘Shari’ah Parameter Reference 1”, p. 1.

<sup>26</sup> See International Organisation of Securities Commission (IOSCO) ‘Analysis of the Application of IOSCO’s Objectives and Principles of Securities Regulation for Islamic Securities Products’ (2008) p. 35.

<sup>27</sup> *Urbun* means a deposit that is considered to constitute partial payment of the price of goods or services paid in advance and it will be retained by the seller in the event that the transaction is cancelled by the buyer. For legal purposes, the confiscated money is considered a *hiba*.

Imam Ali permitted this kind of transaction. In modern terminology, this is similar to the concept of the call option.

#### **4.2.10 Exchange (*Mua'wada*)**

*Mua'wada*<sup>28</sup> (barter) is a transaction whereby the parties to the transaction trade one asset for another without being subject to the requirements of a *bay* contract.<sup>29</sup> In a *mua'wada* contract, one or both of the assets subject to exchange may be tangible or intangible, e.g., benefits, usufructs, services or any other type of financial right. *Mua'wada* may be used in the provision of basic essentials or urgent needs. This facility may also be used in the redistribution of surplus assets to balance the supply and demand in the economy.

#### **4.2.11 Leasing (*Ijara*)**

*Ijara*<sup>30</sup> is an *aqd* (contract) whereby a lessor (an owner or possessor) leases out a property or equipment to a lessee at an agreed rental fee<sup>31</sup> (subject to an immediate payment or an agreed payment schedule in instalments) for a specified period. The ownership of the leased property or equipment remains with the lessor. The lessor will have to bear all the risks associated with the ownership of these assets. On the other hand, the lessee will be considered as the owner of the usufructs and profits arising out of the leased assets and may re-lease the property to another lessee because the lessee holds an interest in the leasehold that entitles him to exclusive possession of

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<sup>28</sup> See Iran Civil Code articles 464-465.

<sup>29</sup> *Mua'wada* means to exchange goods or services without the exchange of money.

<sup>30</sup> See Iran Civil Code articles 466-517. For more detail see Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18th Edition, 1387 Solar Hijri Calendar) pp. 337-382, articles 466- 517.

<sup>31</sup> The rental fee has to be fixed and known to the lessor and lessee right at the beginning of the *ijara* contract.

the leased property. Only the assets or equipment whose existence would not usually disappear as a result of using or benefiting from them could be subject to an *ijara* contract. To be a valid *ijara*, the lessor must deliver the leased property, which is capable of being used properly, to the lessee at the beginning of the *ijara* period. The lessor may ask for any proper security from the lessee for the payment of rental fees. However, the lessee is not liable for any losses or destruction of the leased property unless it has resulted from the lessee's actions. The important applications of *ijara* are in its use in housing, transportation and project finance, e.g., the provision of supplies and equipment for the performance of economic and investment projects. This facility may also be used for microfinance purposes.

#### **4.2.12 Leasing-with-Purchase-Option (*Ijara wa Iqtina*)**

*Ijara wa iqtina*<sup>32</sup> is a type of *ijara* (leasing) contract that allows for the transfer of the ownership of the leased property to the lessee at the end of the leasing period. It begins with the operation of an *ijara* contract for the purpose of leasing the lessor's property to the lessee. Parties stipulate in the *ijara* contract that the lessee, at the end of the lease period, has an option to buy/retain the leased property at an agreed price from the lessor in compliance with the requirements of execution of a sale contract. This facility may be used for the acquisition of necessary equipment and properties, e.g., house purchase finance. This facility may also be used for microfinance purposes.

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<sup>32</sup> Also called *ijara thumma bay*/*ijara bi-shart tamlik*/ *ijara muntahi bi-tamlik*.

#### 4.2.13 Reward Contract (*Ji'ala*)

*Ji'ala*<sup>33</sup> is a unilateral contract which is defined as the promise of a person (*ja'eel*) to pay a known recompense (*jo'l*), in return for performance (e.g., searching for a lost asset) by the other party (*a'mil*), whether the other party is specified by the *ja'eel* or not. The recompense may be a fixed amount of value or a portion of the result of performance (such as from the discovery of a new oil field) or a percentage of its total market value. *Ji'ala* is a permissive contract in that up until the requested act being completed, either of the parties can withdraw; but if the *ja'eel* withdraws during the course of the act of *ji'ala*, he has to pay the *a'mil* reasonable compensation for his acts and efforts. The *a'mil* will become entitled to the reward when he has performed his part of the contract. The subject matter of *ji'ala* must be capable of being owned and it must also embody some reasonable and legitimate advantage, otherwise a *ji'ala* contract would be null and void. This facility may be used in financing the exploration of minerals, for exploration and discovery activities or for innovation and R&D finance. This facility may also be used for microfinance purposes.

#### 4.2.14 Partnership (*Musharaka*)

*Musharaka* is a kind of joint venture scheme. In the early Islamic period, there were two different types of participatory arrangements: *sharkat inan*<sup>34</sup> and *sharkat*

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<sup>33</sup> See Iran Civil Code articles 561-570. Also, see Hasan Imami 'Huquq Madani' (Tehran: Islamiyya, 4<sup>th</sup> edition, 1352 Solar Hijri Calendar) p.123. Furthermore, see Mustafa Adl "Huquq Madani' (Qazwin: Bahr al-Ulum, 1<sup>st</sup> edition, 1373 Solar Hijri Calendar) p. 300.

<sup>34</sup> It was called a capital providers' partnership: an active partnership. The nearest definition for *sharkat inan* in modern terminology is partnership.

*mudaraba*<sup>35</sup>. *Sharkat inan*<sup>36</sup> is a partnership arrangement between two partners or more to finance and run a business venture whereby all participants contribute capital either in the form of cash or in kind. According to the traditional understanding, any profits derived from the venture will be distributed based on a pre-agreed ratio, and losses are distributed according to the proportionate contribution of the partners to the *sharkat inan*.<sup>37</sup> As to *sharkat mudaraba*,<sup>38</sup> it is a type of *musharaka* (partnership) contract which is made between two parties to finance a business venture.<sup>39</sup> The parties are a *rabb al-mal* or an investor who provides all the necessary capital<sup>40</sup> and a *mudarib* or an entrepreneur who manages or provides the necessary labour and expertise for the project or business venture. The entrepreneur is not required to provide security or collateral but all the initial seed assets within the scope and time of the *mudaraba* agreement remain under the ownership of the *rabb al-mal* (financier/investor). If the venture is profitable, as per the traditional understanding,

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<sup>35</sup> It was called a capital & labour providers' partnership: a passive partnership. It was also called qirad. The nearest modern concept for *mudaraba* is entrepreneurship joint venture or venture capital. Some Islamic scholars wrongly believe that the nearest modern concept for *mudaraba* is shareholder company. See A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A.S. Noordeen, 2005) pp 51-52.

<sup>36</sup> See Iran Civil Code articles 571- 606. For detail see Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 401-413.

<sup>37</sup> In case of any dispute as to the rate of distribution (even if it is mutually pre-agreed), the profit ratio is determined on an equity basis, i.e., according to the proportionate contribution of the participants to the partnership. As per some Islamic scholars, any profit derived from the venture will (always) be distributed based on a pre-agreed profit sharing ratio, but the resulting loss will be shared on the basis of equal participation. For this see A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A.S. Noordeen, 2005) PP 51-52.

<sup>38</sup> See Iran Civil Code articles 546-560.

<sup>39</sup> As per Islamic law and as it is reflected in Iran Civil Code articles 546-560, *mudaraba* is for trade purposes. However, it seems to me that the meaning of trade in this context is quite general and it includes investment activities as well. So, *mudaraba* could be used in both trade and investment contexts.

<sup>40</sup> It is believed that the provided capital must be a liquid asset, i.e., cash. For supporting evidence in this regard, see Iran Civil Code article 547. However, in line with the theory in this thesis, the contribution may be in any tangible (hardware).

the profits will be distributed based on a pre-agreed ratio.<sup>41</sup> In the event of an unsuccessful business venture, the loss will be shouldered and absorbed entirely and exclusively by the provider of the capital (barring misconduct or negligence of the entrepreneur). The loss to the entrepreneur is that he earns nothing. As can be seen, in *sharkat inan* and *sharkat mudaraba*, similar to partnership and entrepreneurship joint ventures in modern terminology, the participants/investors share in the profit and loss. This is in contrast to the borrowing and lending technique (as it is practised in the present-day banking and finance world) where, irrespective of the results of investment or trade, lenders receive absolute interest incomes from borrowers. *Sharkat inan* and *sharkat mudaraba* are generally applied to investment, trade, and project financing whether on a large, medium or small (i.e., microfinance business) scale.<sup>42</sup>

In brief, in any economy, collective profit-making activities may occur either actively (where numerous investors pool their own hardware/tangible assets and software/intangible assets in an enterprise, manage it and utilise the fruits of their own contributions) or passively (where an investor or numerous investors provide their hardware/tangible contributions to an entrepreneur and receive a contingent return, but take no further part in the conduct of business). In general, a passive asset holder may have three investment options: a) purchase shares in a

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<sup>41</sup> For more in this regard see Undovitch, Abraham 'Partnership and Profit in Medieval Islam (Princeton, Princeton University Press, 1970) p. 170. As per the research theory, as with musharaka, in case of any dispute as to the distribution of profit (even if the rate of profit is mutually pre-agreed), the distribution is determined on an equity basis, i.e., it has to be determined according to the proportionate contribution of the parties.

<sup>42</sup> One of proposed applications of a mudaraba contract is to cater to small capital-owners who would otherwise go through the bank deposits or bonds, by the introduction of a unit-trust/unit-share type of investment through the operation of investment companies and investment banks. This investment company or investment bank will finance businesses that are currently financed by bank loans. See A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A.S. Noordeen, 2005) pp. 51-52.



company/partnership and receive a dividend; b) purchase securities such as bonds and receive interest; c) deposit in a bank account and receive interest. In Islamic setting, the first passive investment option is permitted while the other two techniques are considered as *riba* (interest) income and therefore forbidden. On the other side, an entrepreneur may finance his venture by using his own assets or selling shares in his business venture but not receiving loan at interest from a financial institution or by issuing debt securities such as bonds.<sup>43</sup>

There are different types of *musharaka* (partnerships).<sup>44</sup> In an Islamic setting, holders of diverse factors of production, i.e., labour, entrepreneurship, capital, material, and the like may set up a partnership<sup>45</sup> on a fixed or flexible term through which to finance a business venture, thereby transacting with third parties as well as among themselves without recourse to *riba*.<sup>46</sup> The contribution of members of a

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<sup>43</sup> See A. L. M. Abdul Gafoor 'Mudaraba-based Investment and Finance' (New Horizon, Journal of the Institute of Islamic Banking & Insurance, 2001).

<sup>44</sup> In contemporary practice, from one perspective, there are three types of *musharaka*: a) permanent *musharaka* in which a partner's interest is an ongoing equity and it is entitled to enjoy its share of the profits as long as the partnership or joint venture continues to exist; b) diminishing *musharaka* in which a partner's equity share is reduced over time as the other partner buys out that partner's share; c) temporary *musharaka* in which a partner provides required working capital of a project for a specified period and receives its share of profit and its principal capital at the end of the project. In this regard consult [www.practicallaw.com](http://www.practicallaw.com)

<sup>45</sup> As per Foster, *musharakas* can be used widely to include all forms of participatory schemes, for many of which the modern law partnership as practised in the West would not be suitable. See Nicholas H. D. Foster 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law' (European Business Organization Law Review, vol. 11, issue 1, 2010) p. 14.

<sup>46</sup> Through the establishment of a partnership, an entrepreneur (or a labour provider) shares in the benefits of the capital contribution of the other partner without becoming involved in a usurious relationship. That is why the establishment of a partnership is a very effective way to substitute interest (*riba*) in many transactions.

partnership may either be in the form of software/intangible assets<sup>47</sup> (e.g. labour, entrepreneurship, know-how, and reputation) or hardware/tangible ones (e.g., capital and materials) or a mix of both. The ownership of the contributions to the partnership will not belong to the partnership as a separate legal entity but to the partners in proportion to their contributions jointly and in an undivided manner. Each partner will remain the owner of his contribution (if distinguishable) or the owner of the total input

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<sup>47</sup> A commonly heard criticism of the contribution of intangible/software is whether it is acceptable, from the viewpoint of Sharia, to consider these intangibles as contributions in partnerships and if they are so, how then can their value be measured. The answer depends on the definition of “maal” (asset) in Sharia. Some Islamic scholars in particular in the Shia school of thought argue that the intangibles are not considered “maal” until after they are released or realised. However, it is worth mentioning here that some Islamic scholars believe that the labour of a partner may be considered as his contribution to the partnership. This approach may also be supported by the implications of Iran Civil Code article 546 concerning *mudaraba*, in particular concerning the contribution of *mudarib*. See Nasser Katouzian ‘Huquq Madani: Uqud Mu’ayyan’ (Tehran: Sahami Intishar, vol.5, no.14). For example, some scholars believe that the labour of a worker is not maal until after it is released and proved by external effects. The expertise, skills, and know-how of an entrepreneur are not maal until after they are actually realised. However, it is fair to say that intangibles, in the same way as tangibles, can be considered maal and can be considered contributions in partnerships. What is important in partnerships is the performance and effectiveness of the contribution throughout the time period of the partnership and its status/condition at the time of making the contribution is irrelevant. Therefore, what differentiates the tangibles from intangibles is the time that the contribution was made to the partnership. The former is made immediately but the latter takes time and it comes into effect throughout the duration of the partnership. Considering these facts, when it comes to the measurement of intangible contributions there are different possibilities. One solution is the mutual agreement of the partners as to the value of the relevant intangible contribution at the time of the contribution. This solution is workable if the other partner knows roughly the value of the relevant intangible contribution. This mutual agreement may be on the basis of *sulh* (compromise) under Sharia. It is well understood that the use of *sulh* is permitted whenever all the characteristics of the subject matter of the agreement are not known to the parties and the underlying subject of their agreement is not illegitimate. However, if the mutual agreement is based on *sulh*, the mutual agreement will be binding and irrevocable with no right of termination unless in exceptional circumstances. The other solution is to measure the value of the intangible contribution periodically (e.g., semi-annually or annually) during the time of the partnership. In this solution, since the intangible contribution has already come into effect the measurement of the contribution will be more fair and reliable. These frequent measurements may be accomplished by mutual agreement between the partners. However, both in the above mentioned first and second solutions, the measurement may be managed by an authorised, specialised entity either in the form of a committee of the partnership or a separate third party entity set up by the House of Market Control (HMC).

in proportion to his contribution (if not distinguishable).<sup>48</sup> In any type of partnership, the division of profits<sup>49</sup> among the partners has to be in proportion (i.e., as a percentage) and not as an absolute amount. In terms of liability towards third party creditors, should the total liquidated capital (hardware values) of the partnership not suffice to satisfy all the debt obligations, the partners will be liable to pay the debts in proportion to their contributions made to the partnership.<sup>50</sup> Therefore, the notion of

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<sup>48</sup>This view is, albeit, in contrast to the modern view where the ownership of the total input belongs to the partnership itself. For practical considerations, however, it is not problematic to consider a separate legal entity for the partnership but without the same exact effects accrued to it in modern practices.

As per Islamic jurisprudence, every shareek (partner) of the musharaka is an agent for the other partners in matters of the joint business. See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) p. 141

<sup>49</sup>These profits have to be actually accrued by the partnership and cannot be contingent profits.

<sup>50</sup>For practical considerations, it is possible that the partners (especially active partners) be considered jointly and severally liable towards the third party creditors. However, eventually the partners themselves will be liable in proportion to their total contributions to the partnership.

There are some Islamic scholars who have also argued for unlimited liability towards third parties in all partnerships (this is consistent with the approach taken in this research in all types of partnerships involved in a business venture). They have also correctly distinguished the way a demand (called *mutaliba*) can be made by the creditors against each partner for the satisfaction of their debt receivables. In a general (i.e., catch-all) partnership like *mufawada* the demand can be made against each of the partners at the creditor's choosing because partners in this partnership are jointly and severally liable (however a partner will not be liable for a debt obligation incurred by his partner if that partner went beyond his authority), but not in the case of a lack of joint and several liability (i.e., where there is only several liability but not joint liability such as in an *inan* partnership) where the creditor can only have recourse to the partner with whom he had contracted. See Abraham Undovitch 'Partnership and Profit in Medieval Islam (Princeton, Princeton University Press, 1970) pp. 100, 239. See also I.A.K. Nyazee 'Islamic Law of Business Organization: Partnerships (The Islamic Research Institute Press, 1998) Ch. 9 particularly § 9.1.2., p. 105 and also § 17.2.1.2., p. 278.

It is worth noting that "unlimited liability" and "joint and several liability" has to be distinguished. For example, in *mudaraba*, *rabb al-maal* has unlimited (proportionate) liability, however he is not liable towards and cannot be sued by the creditors of the partnership (unless under exceptionally certain circumstances) simply because he has no contractual relationship with the creditors. It is the *mudarib* (the entrepreneur) who is liable towards the creditors and can be sued by and can sue the creditors who had contracted with him. Clearly, liability of partnership members is one of the most controversial areas in Islamic business and finance.

separate entity may be practised only for practical considerations but not for the purpose of ownership and liability effects.<sup>51</sup>

In terms of the contribution structure, so-called capital structure in modern terms, *musharakas*/partnerships may be categorised into several forms: tangible-plus-intangible partnership, tangible-plus-tangible partnership, intangible-plus-intangible partnership, and catch-all intangible-and-tangible partnership.

#### **4.2.14.1 Tangible-plus-Intangible Partnership**

*Mudaraba*, *Muzara'a*, and *Musaqat* are discussed under this type of partnership.

##### **4.2.14.1.1 Silent Partnership for Profit-Sharing (*Mudaraba*)**

It is argued that the tangible-plus-intangible partnership (*mudaraba*<sup>52</sup> or *muqarada* or *qirad*<sup>53</sup>) was the very first type of *musharaka* practised by Muslims, including the Prophet himself, and the other types that emerged throughout history are different variants and derivatives of the basic structure of *mudaraba* (*qirad*).<sup>54</sup> As a general rule in *mudaraba*, any profits or losses derived from the business have to be

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<sup>51</sup> As can be seen, this view is in contrast to the dominant view in this regard in modern commercial law.

<sup>52</sup> For the Quranic support of the concept of *mudaraba* see (73:20) "there are among you those ... who are journeying in the land in quest of Allah's bounty".

<sup>53</sup> As per available evidence, the very first *mudarabas* were practised for trade purposes and not for investment. For supporting evidence, see Iran Civil Code articles 546 and 555.

It has been hotly debated that the origins of Medieval European partnerships i.e., commenda go back to Islamic *mudaraba*. For more details in this regard see an article by Abraham Undovitch 'At the Origins of the Western Commenda: Islam, Israel, Byzantium' (Princeton: Princeton University Press, Princeton Near East papers no.9, 1969). For a brief discussion of the debate see Murat Cizakca 'A Comparative Evolution of Business Partnerships, Islamic World and Europe with Specific Reference to the Ottoman Archives' (Leiden: E.J. Brill, 1996) pp. 10-12. Cizakca claims that there are many Sharia concepts that were borrowed and internalised by Western legal systems and the origins of many concepts of Capitalism go back to classical Islamic law.

<sup>54</sup> See Haim Gerber 'The Muslim Law of Partnerships in Ottoman Court Records' (Studia Islamica, vol. 53, 1981).

shared in proportion to the input of each partner in the *mudaraba* partnership.<sup>55</sup> However, for practical purposes, it may be argued that any derived profit or loss will be shared as per the mutual pre-agreement of partners. However, despite the mutual pre-agreement, in case of any disagreement or dispute between the partners their shares have to be determined in an equitable manner, i.e., in proportion to their contributions made to the *mudaraba* partnership. In terms of the liability of the *mudaraba* partners, the entire pecuniary loss up to the total hardware/tangible contribution to the *mudaraba* scheme will accrue solely to the hardware/tangible providers and the loss to intangible providers is that they do not suffer any pecuniary loss, but go unpaid in return for their time, effort, and knowledge (i.e., software or entrepreneurial input) devoted to the *mudaraba* business venture. The excess loss that is going beyond the total hardware/tangible input made to the *mudaraba* will be borne by all the partners in proportion to their share in the partnership. However, it should be noted that some Islamic scholars have different ideas in this regard. Some argue that *mudaraba* is a limited liability partnership and the maximum loss/liability of tangible/capital providers is limited to their capital contributions made to the *mudaraba* and it does not go beyond their capital invested in the *mudaraba* partnership. As to intangible providers (entrepreneurs), it is said that they enjoy absolute freedom from any loss and liability for the capital/tangible input of the *mudaraba* and also are not liable towards third party creditors for their claims against

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<sup>55</sup> In this regard, different Islamic schools of thought have adopted different views. As per Hanafi's view, profit follows mutual agreement and loss follows the amount of contribution (capital) made to the *mudaraba*. As a result, profits may be distributed differently from losses. In other words, according to Hanafi's thought, the partners in a *mudaraba* scheme are absolutely free to agree how to divide the profits of the *mudaraba* partnership among themselves. As per Ibn Rushd, according to both Maliki and Shafi'ee, profits like losses have to be distributed in proportion to the contribution of each partner (according to their capital input) made to the *mudaraba*. See Phillip Issac Ackerman-Lieberman 'A Partnership Culture: Jewish Economic and Social Life Seen Through the Legal Documents of the Cairo Geniza' (Princeton University PhD Thesis, 2007) p. 87.

the *mudaraba* if these claims go beyond the total tangibles/capital of *mudaraba*. However, they are responsible for all the contracts they made with third parties within the scope of *mudaraba*.<sup>56</sup>

The basic structure of *mudaraba* can be considerably enhanced through an arrangement which is called 'multiple *mudaraba*'. Numerous holders of tangible assets may entrust their assets to a single entrepreneur to enjoy more benefits through economies of scale and also minimisation of transaction costs as a result of entrusting many more assets to the entrepreneur. Conversely, a holder of tangible asset may provide some portion of his assets to different entrepreneurs to diversify his risk.<sup>57</sup>

A few very critical issues regarding *mudaraba* are: the type and nature of the input, which has to be provided to the *mudarib*; the scope of investment activities that may be performed under *mudaraba*; and the legitimacy of the guarantee of tangible input by the *mudarib*. Since *rabb al-mal* is a passive and sleeping partner, his contribution has to be in the form of a tangible asset,<sup>58</sup> though it is not necessary for

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<sup>56</sup> See Abraham Undovitch 'Partnership and Profit in Medieval Islam' (Princeton, Princeton University Press, 1970) pp. 100, 171, 239, 242. However, Undovitch himself considers unlimited liability for all forms of partnerships (this view is in accordance with the idea espoused by this research project as to all types of business partnerships).

<sup>57</sup> For some expanded cases in this regard see Murat Cizakca 'A Comparative Evolution of Business Partnerships, Islamic World and Europe with Specific Reference to the Ottoman Archives (Leiden: E. J. Brill, 1996) ch. 3.

<sup>58</sup> The ownership of tangible contributions remains with the *rabb al-mal* and it does not pass to the *mudarib*. The *mudarib* has no right of ownership over the tangible contributions and shares only a contingent right in the profits, which is to be generated from the use of tangible contributed assets. Therefore, the *mudaraba* is categorised under *ahdi* (promissory) contracts rather than *tamliki* (transfer of ownership) contracts. See Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan, Musharakatha-Sulh' (Tehran, Ganj-e-Danesh, 7<sup>th</sup> edition, 2007) pp. 108-109 no. 58.

this to be in cash capital.<sup>59</sup> As to the scope of *mudaraba*, unless a *mudaraba* contract or the common industry practices require otherwise, the *mudarib* can perform any<sup>60</sup> type of trade or investment; however, it has to be legitimate, reasonable and customarily appropriate.<sup>61</sup> As to the guarantee of *mudaraba* tangible assets by the *mudarib*, the *mudarib* has to be in the exact same position as a trustee (*amin*) in the same circumstances. In other words, the *mudarib* is not liable towards *rabb al-mal* for any loss in the *mudaraba* tangible input unless the resulting loss is attributable to gross negligence (*ta'addi*) or reckless indifference (*tafrit*) by the *mudarib*.<sup>62</sup> Moreover, the *mudarib* is not required to guarantee a positive return in *mudaraba* investments. The duty of the *mudarib* is to perform to his best but not to secure a good return.<sup>63</sup>

In addition to *mudaraba*, two other very important classic forms of tangible-plus-intangible partnerships are *muzara'a*<sup>64</sup> and *musaqat*.<sup>65</sup>

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<sup>59</sup> This is in contrast to Iran Civil Code article 547 which requires the contribution of the *rabb al-maal* to be in cash. On the interpretation of this article, some Islamic scholars have argued that the contribution of the *rabb al-maal* may be in the form of any foreign currency (for a supporting idea in this regard see Muhammad Broujerdi Abduh 'Huquq Madani' (Tehran, vol.1, 1950) p.312 and for the opposing idea see Hasan Imami 'Huquq Madani' (Tehran, vol. 2, 3<sup>rd</sup> edition) p. 99), however, not in the form of receivables. It is said that *rabb al-mal* has to hand over the *mudaraba* capital contribution to the *mudarib* in a certain manner and receivables lack this certainty. See Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan, Musharakatha-Sulh' (Tehran: Ganj-e-Danesh, 7<sup>th</sup> edition, 2007) pp. 111-114 no. 61; Allame Hilli 'Tadhkirat al-Fuqaha' (chap-e sangi vol. 2/2) pp. 2 and 22; Allame Hilli 'Qawa'eed al-Ahkam: Kitab al-Qirad' (chap-e sangi); Muhammad Jawad Hussaini A'mili 'Miftah al-Kirama' (Egypt, vol.7, 1947) p.441; Muhammad Kazim Tabatabaee 'Urwah al-Wusqa' (Sida, vol. 2/2, 1349 Lunar Hijri Calendar) p.243.

<sup>60</sup> Some Islamic scholars believe that if the *mudarib* combines the *mudaraba* capital contribution with the capital of third parties to make a partnership or for some other similar purpose, the *mudarib's* legal position as *amin* (trustee) in respect of the capital contributions made by the *rabb al-mal* is converted to the legal status of *damin* (guarantor) unless such a use has already been authorised by the *rabb al-mal*. See Muhammad Kazim Tabatabaee 'Urwah al-Wusqa' (Sida, vol. 2/2, 1349 Lunar Hijri Calendar) p.247.

<sup>61</sup> See Iran Civil Code articles 553 and 555. For more see also Muhammad Jawad Hussaini A'mili 'Miftah al-Kirama' (Egypt, vol.7, 1947) p.447.

<sup>62</sup> For similar approach see Iran Civil Code articles 556 and 558.

<sup>63</sup> See Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan, Musharakatha-Sulh' (Tehran: Ganj-e-Danesh, 7<sup>th</sup> Edition, 2007) pp. 133-134 no. 70.

<sup>64</sup> See Iran Civil Code articles 518-542.

<sup>65</sup> See Iran Civil Code articles 543-545.

#### **4.2.14.1.2 Crop-Sharing Partnership (*Muzara'a*)**

*Muzara'a* is an arrangement set up between two parties for crop-sharing. The parties are a *muzare*, who provides the land and an *amil*, who plants the agreed crops. The *muzare*, the House of Wealth, will act on behalf of the public in *muzara'a* contracts. As it was discussed earlier, as per the research theory, the ownership of all natural resources including lands always remains with the public as a whole. Therefore, there could be no private *muzara'a* contracts. A *muzare* and an *amil* will share the crops based on a pre-agreed ratio, which has to be an equitable ratio. The main responsibilities of a *muzare* are the supply of required water and also payment of all duties levied on the land. The responsibility of an *amil* is to plant, irrigate, grow and harvest the crops. This facility may be used for farming and agricultural business financing and also for microbusiness purposes.

#### **4.2.14.1.3 Fruit-Sharing Partnership (*Musaqat*)**

*Musaqat* is an arrangement made between two parties for produce-sharing. The parties are an owner of trees or similar who provides these trees and an *amil* who maintains and grows them. The owner and *amil* will share the produce, including; fruits, leaves, flowers and similar products based on a pre-agreed ratio, which has to be an equitable ratio. In the same way as the *muzara'a*, this facility may be used in financing of farming and agricultural business and also for microbusiness purposes.

#### **4.2.14.2 Tangible-plus-Tangible Partnership**

*Inan* partnership and *sanduq maliya* (fund) are dealt with under this type of partnership.



#### 4.2.14.2.1 Active Partnership for Profit-Sharing (*Inan*)

In terms of a tangible-plus-tangible partnership, there is one called an *inan* (active partnership). In an *inan* partnership, the contribution of partners is usually unequal.<sup>66</sup> Once they made their contributions to the partnership, the total combined input of the partnership would then belong to all partners<sup>67</sup> in an undivided share, in proportion to their contributions made to the partnership. As a general rule, the partners in an *inan* partnership will share the profits and losses in proportion to their tangible contributions. However, the share of one or some of the partners may be more than their tangible contributions in return for some additional contributions made to the partnership such as management services or some other form of tangible contributions.<sup>68</sup> As to the excess losses going beyond the total liquidated tangible

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<sup>66</sup> However, the contributions may be made in equal amounts.

<sup>67</sup> This idea is in contrast to the modern view which argues for the ownership of the joint capital (total input) by the partnership/company itself as a separate entity and not the members of the partnership. Islamic scholars have also adopted the modern view.

<sup>68</sup> Different Islamic schools of thought hold different ideas in this respect. As per Hanafi's, the general rule is that profit follows the mutual agreement of partnership members and the loss follows the amount of capital contribution. However, the active partners who are involved in the management of the partnership may share in the profits more than their capital/tangible contribution on the basis of a mutual/multilateral agreement between themselves. However, in any case, the share of these partners as regards the loss will be in proportion to their capital/tangible contribution. For a somewhat similar discussion see Vahbah Al-Zuhaily (translated by Mahmoud El-Gamal) 'Financial Transactions in Islamic Jurisprudence' (Damascus: Dar al-Fikr, vol. 1, 2003) pp. 455-456. In contrast, Maliki's and Shafi'ee's argue for the sharing of both profit and loss of the partnership in proportion to the capital contribution of the partners no matter whether they are active or passive partners. See Besir Guzenbenli 'Turkiye Diyanet Vakfi Islam Ansiklopedisi' (Istanbul: ISAM, 2007).

assets of the partnership, the partners will share the liability towards third party creditors in proportion to their total shares in the partnership.<sup>69</sup>

The basic structure of *inan* may be expanded by granting each member of the partnership full trust and power to do with the total assets of the partnership whatever he sees fit. *Inan* may be managed by the partners themselves collectively or individually. One or more of the partnership members may be appointed as managers of the partnership business venture,<sup>70</sup> or the members of the partnership may ask an expert/professional third party to manage the partnership. In this case, the professional manager will be included in the circle of partners and will be considered a member of the partnership whose contribution is his management skills and knowledge, i.e., his intangible contribution. He will be compensated in proportion to his intangible contribution to the partnership rather than given a fixed management fee. This is in contrast to the modern notion of hiring professional managers, who are

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<sup>69</sup> Islamic scholars are divided on this issue. Some believe in unlimited liability (as for any other types of partnership). For example see Abraham Undovitch 'Partnership and Profit in Medieval Islam' (Princeton, Princeton University Press, 1970) pp. 100, 121-122, 135. There are, however, some scholars who argue for limited liability in the *inan* partnership structure. For example see Vahbah Al-Zuhaily (translated by Mahmoud El-Gamal) 'Financial Transactions in Islamic Jurisprudence' (Damascus: Dar al-Fikr vol. 1, 2003) pp. 451-452. Al-Zuhaily argues for several liability (but not joint liability) i.e., each partner in an *inan* partnership is only responsible for the transactions he himself (in his capacity as a partner of the partnership) did with third parties. In other words, as per Al-Zuhaily, in an *inan* partnership, the third party creditors will be compensated for their debt receivables only by the partner with whom they transacted.

<sup>70</sup> In this case the active/manager partners may ask for a greater share in the distribution of the partnership profits in return for their management services. In this case their share in losses will also be adjusted up accordingly. However, while Hanafi and Hanbali schools allow an increase in the share of the active managers in return for their management services, Shafi'ee and Maliki do not permit any extra share for this purpose. See Ismail Buyukcelebi 'Islam Hukukunda Inan Sirketi va Nevileri' (Erzurum: Ataturk Universitesi Doktora Tezi, 1981) p. 69.

usually compensated with a fixed salary. Some scholars have argued that this practice i.e., fixed compensation scheme is allowed in Islamic law on the basis of *wakala*.<sup>71</sup>

#### **4.2.14.2.2 Fund (*Sandug Maliya*)**

*Sandug maliya* is the most common form of *inan* partnership. It is an arrangement in which the contribution of every single participant is made only in monetary form. All partners make a financial contribution into a single fund (*sandug wahid*).<sup>72</sup> In other words, *sandug maliya* is a collective financial investment scheme whereby a joint cash pool is created by participants who seek to earn legitimate profits or other benefits by collective business or investment activities in strict conformity with the precepts of *Sharia*. *Sandug maliya* must operate according to *Sharia* rules and objectives, not only in its relations with participants but also in its investment operations and portfolios.<sup>73</sup> Every single participant may be issued a document evidencing his pro rata share in the fund. This document is called “share”, “unit”, “certificate”, “*sukuk*” or may be given any other similar name. Similar to any other type of partnership/*musharaka*, neither the principal contribution nor the rate/amount of profit can be guaranteed in a financial investment fund. Subscribers of the fund will enjoy, pro rata, any actual profit derived from the business or investment activities of the fund as well as shoulder pro rata losses in the principal contributions made to the

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<sup>71</sup> See Ismail Buyukcelebi ‘Islam Hukukunda Inan Sirketi va Nevileri (Erzurum: Ataturk Universitesi Doktora Tezi, 1981) pp. 67-69.

<sup>72</sup> See Phillip Issac Ackerman-Lieberman ‘A Partnership Culture: Jewish Economic and Social Life Seen Through the Legal Documents of the Cairo Geniza’ (Princeton University PhD Thesis, 2007) p. 82, footnote. 19.

<sup>73</sup> See International Organisation of Securities Commission (IOSCO) ‘Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products’ (2008) p.11. International Organisation of Securities Commission (IOSCO) ‘Islamic Capital Market Task Force Report’ (2004) p. 33.

fund. Furthermore, like any other form of partnership, any business or investment activities conducted by the fund has to conform to the rules and objectives of *Sharia*.<sup>74</sup>

In terms of the type of business or investment activities<sup>75</sup> conducted by the financial fund, *sandug maliya* are categorised into the following:<sup>76</sup> realty & property or

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<sup>74</sup> For a similar view see Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) pp. 139-151.

<sup>75</sup> Any business and investment activities of the fund have to be in strict conformity with the precepts of *Sharia*. No (Islamic or *Sharia*-compliant) collective investment scheme (CIS/fund) can invest in socially detrimental e.g., highly systemically-risky activities or unethical activities e.g. those involving alcohol, pornography or gambling. It can also not invest in institutions or enterprises which are heavily engaged in *riba*-bearing business or investment activities. The criteria to determine whether a given business or investment activity including the capital structure of the fund, tradability of the business or investment product, and the income of the fund is permissible under *Sharia*, is by means of various screening methods which have been developed and introduced in this regard in recent years by Dow Jones Islamic Market Index, AAOIFI, FTSE, S&P 500, MSCI, SEC, and Proprietary (various mutual funds). Typically, *Sharia* advisory boards are involved in Islamic mutual funds or Islamic unit trust funds to ensure that investment and trading activities and portfolios of the fund are conducted according to *Sharia* rules and objectives. See International Organisation of Securities Commission (IOSCO) 'Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products' (2008) pp. 11-13. For more details in this respect see the following online resources: <http://www.djindexes.com/mdsidx/?event=showIslamic> and furthermore, see also [http://www.ftse.com/japanese/Indices/FTSE\\_Global\\_Islamic\\_Index\\_Series/index.jsp](http://www.ftse.com/japanese/Indices/FTSE_Global_Islamic_Index_Series/index.jsp). For different screening methodologies see [http://www2.standardandpoors.com/spf/pdf/index/Shariah\\_Methodology.pdf](http://www2.standardandpoors.com/spf/pdf/index/Shariah_Methodology.pdf)

<sup>76</sup> Any form of fund may be managed either by one or several third party professionals who have not contributed money to the fund or by one or several participants of the fund (or a mixture of both).

In the former case, a *mudaraba* model will be used in dealing with all the rights and duties of the third party managers. According to Taqi Usmani, the majority of the Muslim scholars are of the opinion that a fund cannot be set up on the basis of *mudaraba* if the purpose of the fund is to do transactions on services and leases, because the scope of *mudaraba* is limited to the trade in commodities. However, as per Taqi Usmani, in the Hanbali school of thought, which is followed by a number of contemporary scholars, *mudaraba* can also be used in services and leases. See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) pp. 139-151. It should be noted that, some scholars have wrongfully argued for a *wakala* model in which the management will act as an agent for the fund participants in return for a pre-agreed fixed lump sum fee or a monthly or annual remuneration for its services. Some contemporary jurists (e.g., Taqi Usmani at pp. 139-151) have also wrongly argued that the fee can also be on the basis of a ratio of the net asset value of the fund at the end of every financial year.

In the latter case, the share of the participant managers will be adjusted up in order to claim additional participation in profits to reflect their provision of management services.

real estate investment trusts fund, leasing fund, commodity fund, *murabaha* fund, equity fund, and hybrid fund. These will be discussed below.

#### *Realty & Property Fund*

Realty & Property or Real Estate Investment Trusts (REIT) *sandug* is set up to acquire and manage a portfolio in real estate properties, such as: commercial buildings, hotels, warehouses and garages.<sup>77</sup>

#### *Leasing Fund*

An *ijara* (leasing) fund<sup>78</sup> is created by participants whose contributions are pooled jointly in the fund and are invested in buying assets such as commercial buildings, machinery or other equipment for the purpose of leasing them out to prospective users in return for earning rental fees. The ownership of the leased assets remains with the participants/subscribers of the fund.<sup>79</sup> The earned rentals are distributed to the subscribers proportionally. Every single subscriber of the fund will be issued a certificate called a *sukuk*, showing his proportionate entitlement in the fund (*sandug*). These *sukuk*, representing the pro rata share of the *sukuk* holders in the underlying assets of the fund, are fully negotiable by their holders.<sup>80</sup>

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<sup>77</sup> For more see International Organisation of Securities Commission (IOSCO) 'Islamic Capital Market Task Force Report' (2004) p. 32.

<sup>78</sup> For more detail see Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) pp. 139-151.

<sup>79</sup> This view is clearly in contrast to the modern view, which advocates the ownership of assets by the fund itself.

<sup>80</sup> From the viewpoint of Sharia, it would be problematic if the underlying assets of the *sukuk* were monetary i.e., liquid assets or receivable debts.

### *Commodity Fund*

A commodity fund is created for commodity trading purposes. In this fund the subscription amounts received from the participants are invested in purchasing a variety of *halal* goods<sup>81</sup> for the purpose of their resale and for profit-making. The profits produced by the trade of goods, mostly metals, such as: copper, iron, aluminium, or nickel is distributed pro rata among the participants. Similar to other funds, participants of the commodity fund may be issued *sukuk*, representing the pro rata share of the *sukuk* holders in the underlying assets of the fund. These *sukuk* are negotiable.<sup>82</sup>

### *Cost-plus Sale (Murabaha) Fund*

A *murabaha* fund is created for trade financing purposes. In this fund the pooled money is used to procure the goods and commodities from third party suppliers requested by prospective clients. Having acquired the requested goods and commodities, a *murabaha* fund then immediately resells the procured items to the prospective clients on a deferred payment basis at an agreed margin of profit added to the original cost of the commodities. As per some Islamic scholars, this fund, unlike many other funds, is a closed-end fund and its units (*sukuk*) are not negotiable (in a secondary market). The reason provided in this regard is that in the *murabaha* fund the payment of the resale price is being deferred and it becomes payable by the client in regular instalments in the future. In other words, the portfolio of a *murabaha* fund does not often include tangible assets but comprises either cash or the receivable debts, which are not negotiable according to *Sharia* rules. If the receivables are

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<sup>81</sup> For example dealing in alcohol and haram meat (like pork). These are prohibited according to *Sharia*.

<sup>82</sup> As per Taqi Usmani, most transactions carried out in the modern commodity markets, especially in the futures commodity markets, are not in compliance with the rules of *Sharia*. See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) p. 148.

exchanged for money, they must be traded at par value to avoid *riba*.<sup>83</sup> However, it should be added that the sale and purchase activities by a *murabaha* fund have to be reflected in its balance sheet and so it is hard to say that its portfolio does not include any tangible assets although these are often sold immediately. In other words, one may argue for the negotiability of the *murabaha* fund *sukuk*.

### *Equity Fund*

An equity fund is created to invest the pooled contributions of money in the acquisition of the shares of *halal*-oriented<sup>84</sup> business associations. In this respect, the profits of the fund participants are basically derived from the capital gains and also the distribution of dividends by the relevant ventures on the basis of pro rata profit-sharing.<sup>85</sup> The participatory nature of this fund in terms of sharing profits and losses of the relevant business ventures on a pro rata basis, has contributed significantly to its

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<sup>83</sup> See Muhamad Taqi Usmani 'Principles of Shariah Governing Islamic Investment Funds' Available via the Internet at [http://www.albalagh.net/Islamic\\_economics/finance.shtml](http://www.albalagh.net/Islamic_economics/finance.shtml)

<sup>84</sup> From the Sharia viewpoint, in determining whether a given business action of the business venture in which the funds are invested is attributable to the fund participants, some scholars argue that since all the actions and policy decisions of *musharakas* (business partnerships) have to be taken on the basis of consensus of all the partners and every single partner holds a veto power as to the business policy of the partnership, so, all the transactions of the business partnership are basically attributable to every single participant. Clearly, this is in contrast to the modern policy decisions practised by conventional business companies in which the decisions are taken on the basis of majority vote of the equity holders. So, each and every business action conducted by the modern business company is not necessarily attributed to every single equity holder. See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) p. 139-151.

<sup>85</sup> However, as per some Islamic scholars, to the extent that the profits of such business associations are earned from non-halal activities, a "purification" process will have to be followed by the investor participant. Islamic jurists hold diverse views about the necessity of 'purification' where the profits are derived through capital gains. Some jurists argue for the necessity of 'purification' because they believe that the market price of the shares of a business association may reflect an element of interest in the value of assets of the business association. The other view argues for unnecessary purification in the case of capital gain, due to the reason that no specific part of the value of shares of the business association can be allocated for the interest that is arguably reflected in the value. See Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) p. 139-151.

popularity and also attractiveness for many investors especially those who are looking for an Islamic investment.

#### *Hybrid Fund*

A hybrid fund may be set up if the purpose is to invest the contributions of the fund received from the participants in different types of business and investments, such as: equities, commodities, leasing, and real estate. In order for the units, shares, or *sukuk* of the fund to be tradable, non-monetary assets of the fund must be worth a considerable amount. However, according to the majority of contemporary *Sharia* scholars, according to Taqi Usmani,<sup>86</sup> for *sukuk* to be negotiable, the tangible assets of the fund have to account for more than 51% of the total assets of the fund, i.e., the liquid and monetary portion of the assets of the fund must not exceed 50%.

#### **4.2.14.3 Intangible-plus-Intangible Partnership (Credit Partnership)**

A further type of partnership that will be discussed is the intangible-plus-intangible partnership. This is known as *wujuh/mafaalis* (credit partnership) and involves sometimes two or more persons who have good credit, good reputations, expertise, and knowledge who establish a partnership without contributing any finances. For example, two or more lawyers may set up partnership to provide legal services; investment advisors to provide investment advisory services; and, merchants to buy merchandise on credit and sell it for an immediate financial return.<sup>87</sup> The

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<sup>86</sup> See Muhamad Taqi Usmani 'Principles of Shariah Governing Islamic Investment Funds' Available via the Internet at [http://www.albalagh.net/Islamic\\_economics/finance.shtml](http://www.albalagh.net/Islamic_economics/finance.shtml). See also Muhammad Taqi Usmani 'An Introduction to Islamic Finance' (Hague: Kluwer Law International, 2002) p. 151

<sup>87</sup> Ibn Taymiyya and his student Ibn Qayyim have rejected *wujuh* due to the reason that it circumvents *riba*. See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar, Studies in Islamic Finance, Accounting, and Governance, 2011) pp. 145, 159 no. 49.



partnership members will share the profits and also losses in proportion to their contributions.<sup>88</sup>

#### **4.2.14.4 Catch-all Intangible-plus-Tangible Partnership (General Association)**

The final type of partnership that will be examined is the catch-all intangible-plus-tangible partnership<sup>89</sup> (general association).<sup>90</sup> This is where two or more persons create a general association to share all their acquisitions (and losses if any) for a limited period of time or for their whole lives, in exactly equal (often) or in unequal

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<sup>88</sup> This type of partnership is rejected by Shafiee and Maliki from Sunni schools of thought as well as the Shi'a school of thought (some Islamic scholars have wrongly argued that Shi'a school accepts this partnership; see Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar, Studies in Islamic Finance, Accounting, and Governance, 2011) p. 33). For the true position of Shi'a (i.e., rejection of wujuh partnership) see Murtaza Mutahhari 'Barrasiye Ijmaliye Mabaniye Iqtisade Islami' (Tehran: Hikmat Publications, 1<sup>st</sup> Edition, 1403 Lunar Hijri Calendar) p. 259. In contrast, wujuh partnership is accepted by Hanafi and Hanbali schools of thought. For a critique of the position of Shafi'ee by the Hanafi school see Abraham Undovitch 'Partnership and Profit in Medieval Islam' (Princeton, Princeton University Press, 1970) pp. 81-83. For more see also Osman Sekerci 'Islam Sirketler Hukuku' (Istanbul: Marifet Yayinlari, 1981) p. 238. As per the school of Hanafi, wujuh partnership is the only partnership in which the profits have to be strictly divided in proportion to the contributions of the partners made to the partnership but not according to the mutual/multilateral agreement of the partners.

<sup>89</sup> It is also called *mufawada/abdan/a'mal* partnership. It is a kind of communality that comprehends all tangible and intangible belongings of the partners. Likewise all other types of partnerships, this partnership is also an unlimited (proportionate) liability partnership.

<sup>90</sup> The Shi'a school of thought rejects all these types of partnerships mainly because of the existence of gharar and also the spread of the spirit of dependence among people in society. See Murtaza Mutahhari 'Barrasiye Ijmaliye Mabaniye Iqtisade Islami' (Tehran: Hikmat Publications, 1<sup>st</sup> edition, 1403 Lunar Hijri Calendar) pp. 259-260.

proportions (rarely).<sup>91</sup> In these cases, if it does not matter whether the source of acquisition is business, inheritance, a gift or in fact any other source, it is called *mufawada*; but, if it is limited to the acquisitions acquired only by an effort and act of the partner and not from inheritance, gift or similar sources, it is called *abdan* or *a'mal*.<sup>92</sup> In this partnership, it does not matter whether the devotion of time and effort of the partners is equal or not. Some may argue that this type of partnership has to be declared void on the basis of the concept of *gharar* simply because the contribution of each partner is not specified and is uncertain.<sup>93</sup> At the same time, others may argue it is valid on the basis of the concept of *sulh* (simply because any type of compromise is permitted unless it is a compromise on an illegitimate issue). It seems the former argument is solid enough to declare this type of partnership null and void. The other argument for rejecting this *musharaka*/partnership could be the implications of one of the general policies shaping the alternative intellectual model provided in the thesis, as it encourages the fostering and the strengthening of the spirit of independence and

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<sup>91</sup> Some Islamic scholars have provided a different definition. As per Cizakca, in a mufawada partnership "partners contribute capital in exactly equal amounts to the venture and share profits, as well as losses, in exactly equal proportions". See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar, Studies in Islamic Finance, Accounting, and Governance, 2011) p. 33. It seems if this is considered to be the definition of mufawada, it would in fact be a type of inan partnership structure but not a new separate type of partnership as it is discussed here.

It can be said that the essence of mufawada is the mutual agency (on the basis of wakala) and mutual guarantee (on the basis of aqd daman and also kafala). Each partner is considered to be the other partner's wakil (agent) and also damin/kafil (guarantor). In other words, in mufawada, the partners are jointly and severally liable for all the debts of partnership and indeed for each other. Each partner confers upon his partner full power to dispose of their joint capital in any reasonable manner for the best interests and benefit of their partnership. From this perspective, as per Foster, mufawada is similar to an English partnership. See Nicholas H. D. Foster 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law' (European Business Organization Law Review, vol. 11, issue 1, 2010) p.17

<sup>92</sup> As to losses, however, it would not matter whether the cause of loss is business or natural disaster or any other cause.

<sup>93</sup> It may be argued that if the purpose of these partnerships is to make profit at the expense of other partners, it has to be declared void; but, however, if the purpose is merely a kind of security or insurance it would be a legitimate, valid partnership.

self-reliance among individuals rather than encouraging them to be dependent on each other and be enriched unjustly.

#### 4.2.14.5 Conclusion

From the viewpoint of a contribution structure (a so-called capital structure in modern terms), the legitimacy of different types of partnerships in different Islamic schools of thought is as follows: Shia, Shafi'ee, and Maliki<sup>94</sup> reject *wujuh and mufawada* but allow *mudaraba* and *inan*; Hanbali rejects *mufawada* but allows all other types; and Hanafi<sup>95</sup> allows all the types of partnerships mentioned above. Regarding the problem of profit and loss sharing in each type of *musharaka*, as per the Hanafi school of thought, profit in all types of partnerships (except in a *mufawada* partnership) must be divided according to the pre-mutual-or-multilateral agreement of the partners in which loss follows (capital) contributions of the partners (except in the case of a *mufawada* partnership in which profit and loss must be divided equally); as per all other Islamic schools of thought, profit and also loss has to be divided in proportion to the (capital) contribution of the partners made to the joint venture.<sup>96</sup>

It can also be concluded from the above that both conventional and Islamic finance allow and foster active investment, which rewards intangible and tangible contributions from realised revenues. Both also allow and encourage passive

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<sup>94</sup> It seems Shia, Shafi'ee, and Maliki have adopted a very narrow definition of maal (asset) and so have strictly limited the type of contributions which may possibly be made to a partnership (i.e., they have limited the contribution to only capital or at most the tangible assets). However, I would argue for a very wide definition of maal (asset) that may be contributed to a partnership and that is why I use the term contribution or input for any type of economically valuable software/intangible and hardware/tangible assets.

<sup>95</sup> For a standardised (codified) view of the Hanafi school on different musharakas see Majallat al-Ahkam al-Arabiyyah articles 1329-1448.

<sup>96</sup> For support for the Shia view see Iran Civil Code article 575.

investment in shareholder companies which reward tangible contributors, e.g., capital providers from realised income in the form of dividends. In both cases, according to Islam, any realised pecuniary loss is solely burdened by the tangible contributors.<sup>97</sup> Unlike conventional financial practices, any investment that brings in a guaranteed return or any financing that involves the payment of a guaranteed interest is forbidden in an Islamic financial system.<sup>98</sup>

### **4.3 Applications of Alternative For-Profit Products and Collective Schemes**

The following are the major financing alternatives for for-profit activities.

#### **4.3.1 The Government/Public Income-Creating Projects**

Since *riba* is prohibited in Islam, the Islamic government cannot issue interest-bearing treasury bills, treasury bonds and/or borrow interest-based sovereign debt.<sup>99</sup> To carry out income-creating public and infrastructure projects, governments today often issue bonds to the public which are essentially long-term loans. Their face

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<sup>97</sup> However, as it has been discussed earlier, in bankruptcies where the total liquidated assets of the partnership is not sufficient to satisfy all debts, the intangible contributors will be liable towards the third party creditors of the partnership in proportion to their share in the partnership.

<sup>98</sup> For similar views see A. L. M. Abdul Gafoor 'Participatory Financing through Investment Banks and Commercial Banks' (The Netherlands: Aptec publications, 1996; also published in Malaysia by A. S. Noordeen, KL; also a shorter version of it has been published in New Horizon, July 2001).

<sup>99</sup> See Salman Ahmed Shaikh 'Sources of Public Finance in an Islamic Economy' (Islamic Economics Project, 17 April 2010) p. 1.

value<sup>100</sup> is guaranteed on maturity and they are sold at less than their face value. This deduction in payment on issue is a return or in fact interest for their holders. This makes it problematic from a *Sharia* point of view. Moreover, in addition to the concern over monetizing its deficit (i.e., public debt) by an Islamic government,<sup>101</sup> some studies have shown concern over the operation of Islamic finance rules in the pricing of loan products between countries and Islamic financial institutions.<sup>102</sup> Furthermore, some argue that since the funds raised by governments through issuing bonds are not invested in profitable enough projects or they are invested in long-term projects, they are unattractive for investors and they will not have enough incentives to participate in funding such projects.<sup>103</sup> To address these concerns, different solutions have been suggested or applied in practice. Some Islamic states have designed and issued government bonds on the basis of profit and loss sharing schemes. Another solution has suggested avoiding the problem of *riba* in issuing government bonds by denominating and issuing these bonds using a gold-units basis in which the fund providers will acquire no return on their capital, but will not shoulder any losses

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<sup>100</sup> Face value is what is written on the face of the bond and it is determined by the issuer of the bond (in the case of paper currencies the face value is determined by the power of the state which makes them legal tender). This is different from the intrinsic value which is linked to the market value of the underlying asset, which is demonstrated by the bond (in the case of coins, the intrinsic value is the cost of the production of the coin plus the value of the metal that it contains. For example, if it contains gold, the value of the gold is its equilibrium price determined by the global commodity market). Under normal conditions, the face value is always greater than (or at least equivalent to) the intrinsic value; however, this is not always the case. See Zubair Hasan, 'Ensuring Exchange Rate Stability: Is return to gold (Dinar) possible?' (JKAU: Islamic Economics, vol. 21, no. 1, 2008) pp. 1-21.

<sup>101</sup> See Ali F. Darrat and Abdel-Hameed M. Bashir 'Modeling Monetary Control in an Interest-Free Economy' (JKAU: Islamic Economics, vol. 12, 1420 Lunar Hijri Calendar) pp. 3-19. Monetizing means transforming public debt (deficit) from securities into legal tender i.e., currency that can be used to buy goods and services.

<sup>102</sup> See B. Muralidhar Reddy 'Of Religion and Economics' (Frontline. vol. 18, issue 11, 2001).

<sup>103</sup> It seems this argument is not strong enough simply because governments may invest the raised funds in attractive profit-making projects. The Iranian government has used this scheme (Islamic bonds) to finance some large-scale and profit-making oil, gas, and petrochemical projects.

caused by inflation.<sup>104</sup> Some Islamic scholars<sup>105</sup> have proposed the issuance of GDP growth linked instruments ('nominal GDP growth rate as the benchmark for pricing' the products) to finance government domestic/foreign loans. Another more suitable and practical alternative method for sovereign borrowing (foreign debts) is to use a middle way of guaranteed and contingent return on borrowings. In today's world, it is not fair to impose all the burdens on the debtor government. The world financial markets are too interconnected and a risky event in one part of the world may create a lot of negative externalities on the debtor government which made no contribution to the creation of these externalities. Therefore, it is not fair that governments are penalised for all these externalities which are often out of their control and which they had no hand in creating. The inherent problem of the current prevailing sovereign bonds is that the return for bondholders is guaranteed regardless of the likely occurrence of these externalities. This is an irresponsible and disproportionate way of sharing risk and is akin to gambling. In practice, however, the capital providers look for guaranteed returns and they may be less likely to provide their capital to foreign governments on a contingent return basis. So, one possible option is the establishment of an internationally (at least, regionally) supported mega-financial institution which will take the capital of money providers on the fixed return basis (which can in turn be benchmarked to the growth rate of the world economy or the debtor government's),

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<sup>104</sup> In these cases, investors do in fact provide their funds with no return on their capital and only with a patriotic (fi-sabilillah) motive. However, from an Islamic viewpoint, in these cases a moral burden is transferred to the government. The funds should be used properly and only for good causes. See A. L. M. Abdul Gafoor 'Islamic Banking & Finance: Another Approach' (A.S. Noordeen, Kuala Lumpur, Malaysia, 2000) pp 24-25.

<sup>105</sup> See Salman Ahmed Shaikh 'Sources of Public Finance in an Islamic Economy' (Islamic Economics Project, 17 April 2010) p.5. See also Salman Ahmed Shaikh 'Role and Functions of Central Bank in Islamic Finance' Available via the Internet at [http://mpira.ub.uni-muenchen.de/26702/1/Central\\_Banking\\_in\\_Islamic\\_Economy.pdf](http://mpira.ub.uni-muenchen.de/26702/1/Central_Banking_in_Islamic_Economy.pdf) and also <http://www.islamiceconomics.jigsy.com>

but its lendings to the fund applicant governments will be on a contingent basis, e.g., using some kind of *musharaka* model.

Public income-creating projects such as the development of oil and gas fields, and telecommunication infrastructure can be funded using equity modes of financing or issuing investment securities (i.e., *sukuk* instruments).<sup>106</sup> The combination of *musharaka* (in particular declining balance shared equity) with *mudaraba* and *ijara* (or *ijara-wa-iqtina*) or the combination of *istisna* with *ijara* or *ijara-wa-iqtina* arrangements can be used whereby financing will be conducted using the issuance of appropriate *sukuk* securities.<sup>107</sup> In the case of a combination of *musharaka* (in particular declining balance shared equity) with *mudaraba* and *ijara-wa-iqtina* (or *bay nasiya*), the state<sup>108</sup> (or a state enterprise) by way of engagement of a financial intermediary (*wakil*) would issue *musharaka sukuk* to investors. The state and investors would establish a *musharaka* (partnership) arrangement. The collected capital from the investors (which constitutes a large portion of the *musharaka* capital) and the contributed capital by the state itself (which is a very small part of the total capital) will be placed with a *mudarib* (a contractor or an entrepreneur), who would use them to complete the project on the basis of a *mudaraba* agreement with the *musharaka*. The income or profits arising out of the project as a result of *bay nasiya* or *ijara-wa-iqtina* to the state would be shared between the *mudarib* and *musharaka*. The investors (*musharaka sukuk* holders) together with the state are considered the

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<sup>106</sup> See Nadeem Ul Haque & Abbas Mirakhor 'The Design of Instruments for Government Finance in an Islamic Economy' (International Monetary Fund, IMF Working Papers 98/54, 1998).

BOT (Build, Operate, and Transfer) and BOO (Build, Own, and Operate) are the most popular modern modes of financing in public utility projects such as power plants and transportation infrastructure.

<sup>107</sup> For a similar idea see Nadeem Ul Haque & Abbas Mirakhor 'The Design of Instruments for Government Finance in an Islamic Economy' (International Monetary Fund, IMF Working Papers 98/54, 1998).

<sup>108</sup> What is meant by the state or government here is the House of Wealth according to the research theory.

owners of the project. Using declining balance shared equity (*musharaka*) the state would gradually (in the case of using *bay*) or at the end of the lease (in the case of using *ijara-wa-iqtina*) buy out the share of the investors. In this arrangement, *musharaka sukuk* holders would be able to exchange or trade their *sukuk*. These *musharaka sukuk* are suitable for investors who are looking for tradable and liquid *sukuk* and also for investors who are looking for a medium risk, long term investment.

Very similar modes of financing to the above model are used in practice in public infrastructure development projects, such as bridges, highways and dams through a quasi-equity finance or public-private participation scheme. The quasi-equity finance *sukuk* called Revenue Participation Scheme instruments were introduced by the Turkish government in 1984 and used for construction of the First Bosphorus Bridge in Istanbul in December 1984 as well as the Keban dam in January 1985.<sup>109</sup> According to the quasi-equity finance scheme, the prospective revenues generated from the project are sold to members of the public who are issued with certain shares (*sukuk*)<sup>110</sup> according to their contribution of equity capital to the project. The reason for calling it quasi-equity finance rather than typical equity finance is simply because the ownership of the constructed building is to be retained by the state and the investors receive only the annual revenues generated by the project. To follow a true *musharaka* arrangement, the transmission of ownership from the public investors to the state may also be accomplished using a declining-partnership arrangement whereby the investors together with the state would in the first stage share the ownership of the

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<sup>109</sup> It was the Public Housing and Partnership Directory (one of the governmental agencies) who initiated this arrangement and handled the issuance of relevant shares/*sukuk*. See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar, Studies in Islamic Finance, Accounting, and Governance, 2011) pp. 165, 172-173.

<sup>110</sup> It is worth noting that *sukuk* are securities-like instruments in modern Islamic finance. *Sukuk* may be used in a very wide context, from private business finance to public finance. In public finance, *sukuk* are used for public borrowing or public investment purposes.



project but their ownership share will be gradually reduced as a result of annual payments to the investors.

Other interesting Islamic finance instruments are *sukuk* used for public borrowing, such as the First Malaysian Global Sovereign *Sukuk*.<sup>111</sup> These *sukuk*, which were structured on the basis of *murabaha* and *bay al-dayn* concepts were issued in 1997 by the Malaysian government's investment agent called Khazanah Nasional Berhad.<sup>112</sup> Later, in 2006, Khazanah issued a new series of *sukuk* based on the concept of *musharaka* (which is more respectable from the viewpoint of *Sharia*), linked to the performance of the telecommunication industry in Malaysia.<sup>113</sup>

In 2001, the Central Bank of Bahrain issued *sukuk* for public borrowing known as *salam sukuk*. For this purpose, the Government of Bahrain sold a specified commodity of aluminium to the investors i.e., *sukuk* holders for delivery in 3 months for a certain price at the time of the issuance of *sukuk* (at the time of the sale contract). These *sukuk* issued on the basis of *salam* are considered fixed income instruments. That is why they soon became popular tools for liquidity management purposes.<sup>114</sup>

The other global sovereign *sukuk*, after the Malaysian one, was issued by the Department of Civil Aviation of Dubai in October 2004. These *sukuk* have been considered the greatest *sukuk* issued so far.<sup>115</sup> The next largest series of *sukuk* structured as convertible *sukuk* (convertible into equity upon an IPO) and also known as *musharaka sukuk* was launched in January 2006 by the Dubai Ports, Customs and

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<sup>111</sup> For detail in this regard see Saiful Azhar Rosly 'Critical Issues on Islamic Banking and Financial Markets' (Kuala Lumpur: Dinamas, 3<sup>rd</sup> print, 2008).

<sup>112</sup> See Mohamad Akram Laldin 'Islamic Financial System' (Humanomics, vol. 24, no. 3, 2008) p. 230.

<sup>113</sup> See Securities Commission Malaysia 'Sukuk' (Kuala Lumpur: Sweet and Maxwell Asia, ICM Series, 2009).

<sup>114</sup> See Sayd Farook 'Salam Based Capital Market Instruments (in Securities Commission Malaysia, Sukuk)' (Kuala Lumpur: SCM, 2009) pp. 163-168.

<sup>115</sup> See Rafe Haneef 'The Sukuk Market, the Challenges Ahead' (Paper presented at INCEIF, June 2008) p. 6.

Free Zone Corporation (PCFC) to transform the PCFC into one of the world's greatest port operators.<sup>116</sup>

Interestingly, in 2004, it was a European country, Germany, that launched *sukuk*. The *sukuk* were issued by one of the states of Germany, namely Saxony Anhalt, and it raised €100 million from both Middle Eastern and European investors through the issuance of triple A rated and five-year Islamic bonds. The issued *sukuk* were secured by real estate assets held in a trust, an SPV or foundation or Islamic *waqf*-like institution, which was established in the Netherlands for tax advantages as well as due to a more favourable securitisation law.<sup>117</sup>

In conclusion, the most important advantage of asset-based public borrowing is that they allow states as well as large businesses to profit from their otherwise idle properties by securitising them. Also, the idle savings of the members of the public are channelled to the infrastructure development projects and they receive good returns without containing any *riba* element.

#### **4.3.2 The Wholesale and Retail Shopping**

In the area of wholesale and retail shopping, a prospective retailer who lacks sufficient funds to buy the necessary goods and supplies may purchase these from a relevant wholesaler on the basis of *bay nasiya* (deferred sale) or *murabaha* (payment in instalments with a certain mark-up). For day-to-day shopping transactions, the retailer can in turn issue credit cards on the basis of *murabaha* (or *bay nasiya*) to the

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<sup>116</sup> See Mohamed Ridza Abdullah 'Regulatory Issues: Innovations and Application in Sukuk- in Securities Commission Malaysia, Sukuk' (Kuala Lumpur: SCM, 2009) pp. 80-82.

<sup>117</sup> These *sukuk* received double A rating by S&P and triple A by Fitch. See Mahmoud A. El-Gamal 'Islamic Finance: Law, Economics, and Practice' (Cambridge University Press, 2006) p. 113. See also Ayman H. Abdel-Khaleq and Christopher F. Richardson 'New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings' (Chicago Journal of International Law, Vol. 7, Issue 2, Winter 2007) p. 413.

prospective consumers/customers, who will pay the purchase price using the issued credit cards by the retailer.

### **4.3.3 Converting Illiquid Assets into Cash**

In some circumstances a person may need immediate access to cash to discharge his current debt obligations or to run his business. In these circumstances, the owner of illiquid asset may use a *bay shart* (also called *bay wafa*) facility to sell his illiquid<sup>118</sup> properties to a cash buyer and then lease (*ijara*) them back from the buyer to continue his normal use of the assets in return for the payment of agreed rental fees to the buyer. In case the seller can pay the agreed price in the agreed time to exercise his option of cancellation of the sale contract, he will regain the ownership of his previously-sold assets.

### **4.3.4 The Commercial Construction and Infrastructure Projects**

For the commercial housing and construction business, the combination of *musharaka/mudaraba* with *murabaha/ijara*, and the combination of *istisna* with *salam* could be very suitable in this regard. Using a *musharaka* arrangement, partners may agree to contribute their capital, labour, expertise, supplies and equipment for the purposes of construction of houses or any other types of buildings: such as a lodging, a warehouse, a plant or factory to share the profits of the business pro rata of their contribution. All contributions of the partners will be mobilised in a *musharaka* scheme. In this case, *musharaka* partners (investors) are issued with certificates, i.e.,

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<sup>118</sup> Not only can it be illiquid properties but also those properties, e.g., a living residence, that the seller is unwilling to dispose of or to alienate the title in an absolute manner and wants to buy it back at his earliest convenient time.

*sukuk* indicating their pro rata ownership in *musharaka*. *Musharaka sukuk* holders will be able to exchange or trade their *sukuk* in financial exchange markets. These *sukuk* are suitable for investors who are looking for tradable and liquid *sukuk* and also suitable for investors who are looking for a less-risky and medium term investment. In *mudaraba*, a type of *musharaka*, an owner of capital, supplies and equipment may agree with a contractor where the latter undertakes to construct buildings at the expense of the former and share the profits of the construction business. In both above mentioned types of *musharaka*, after construction projects are completed, profits can be made from mark-up sales as per *murabaha* or rental fees by using *ijara* and also rental fees plus sale price in the end in accordance with *ijara-wa-iqtina*. Another suitable scheme for commercial construction is *istisna*. As per *istisna*, the contractor would have to construct houses or any other type of building in accordance with the specifications set out in the construction/purchase order of buyers who agree to purchase and pay the price of the house or similar building in advance (using a *salam* contract facility) or gradually in accordance with construction progress. The contractor will issue certificates (i.e., *salam sukuk*) to the customers, who would in turn be able to trade and exchange these certificates in financial exchange markets.

A modern mode of financing which is regularly used in construction and also in energy and infrastructure sectors is project finance. Project finance has been attractive for many reasons; however, different projects require different financing structures. The most common characteristics of modern project finance are: a) the existence of a Special Purpose Entity or Vehicle (SPE or SPV); b) high leverage; c) a long term capital structure; d) non-recourse debt; e) extensive and complex contracts; f) attempts at risk allocation; g) security for lenders through protective covenants (such as provisions requiring new debt to be junior and subordinated to senior debt). Although this structure seems to be very similar to the *mudaraba* scheme in Islamic finance; however, it is not for the following reasons: a) in *mudaraba*, the return for the

financier is not guaranteed but the financier shares in the realised profits of the project, if any at all; b) in *mudaraba*, the financier remains the owner of its own provided capital to the scheme and the ownership of the funds neither transfers to the project (SPV) nor the entrepreneur/contractor; c) as per *Sharia*, the creation of a separate legal entity as an SPV in order to transfer some assets to limit the liability of the creator of SPV is not allowed;<sup>119</sup> d) the payment of a guaranteed interest on the loans provided by the financier is prohibited according to *Sharia*.

#### 4.3.5 The Agriculture and Farming Projects

Suitable financing schemes for agriculture and farming business are *muzara'a* (crop-sharing), *musaqat* (produce-sharing), *salam* (forward sale), bay nasiya (deferred payment sale), *ijara* (leasing) and *a'riya* (using other peoples' property free of charge). As per a *muzara'a* agreement, a land owner<sup>120</sup> provides a farmer with the required land where the latter plants and shares the crops with the former. In *musaqat*, an owner of trees and similar plants provides trees for a farmer, who then maintains and grows the trees and shares its produce (fruits, leaves, flowers and similar products) with the owner of the trees. In case the land owner and farmer are in desperate need of funds, they can sell their prospective crops and produce in advance on the basis of a *salam* contract (forward sale). *Bay nasiya* (deferred payment sale of agricultural and farming equipment, supplies and machinery), *a'ariya* (a permission to use agriculture and farming equipment, supplies, and machinery free of charge temporarily) and *ijara* (leasing temporarily the agricultural and farming equipment, supplies, and machinery

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<sup>119</sup> In contemporary Islamic finance practices, the concept of limited liability and also the establishment of a separate legal entity are used almost with no objection. However, as discussed in this thesis this practice is in sharp contradiction with *Sharia*.

<sup>120</sup> As per the research theory, the ownership of natural resources including lands always remains with the public as a whole (which is administered by the House of Wealth on behalf of the public as a whole).

in return for payment of certain rental fees) may be used for the procurement of supplies and equipment required in agriculture and farming, such as: seeds, water, tractors, and combine harvester machinery. Both in *muzara'a* and *musaqat*, a pool of investors may set up *musharaka* with the land owner and provide farmer with the required capital and other necessary materials and then share the crops, timbers or produce. In this case, the investors (*musharaka* partners) will be issued with certificates, i.e., *sukuk*, indicating their *pro rata* ownership in *musharaka*. They will be able to exchange or trade these *sukuk* in financial exchange markets. These *sukuk* are suitable for investors who are looking for tradable and liquid *sukuk* and also those investors who are looking for a less-risky and short term investment.

#### **4.3.6 The Livestock-Raising Activities**

A livestock owner and grazier may agree that the former provides livestock and the latter breeds, guards and tends the livestock to share the meat, milk, dairy products or similar produce from the livestock based on a mutually pre-agreed equitable ratio. It is clear that this arrangement is similar to *muzara'a* and *musaqat* in agriculture and farming business and also the use of *mudaraba* in investment business. A *musharaka* can also be established to acquire livestock. In this case, *musharaka* partners (investors), as the stock owners will be issued with certificates, i.e., *sukuk*, indicating their *pro rata* ownership in *musharaka*. The *sukuk* holders will be able to exchange or trade these *sukuk*. Therefore, these *sukuk* are suitable for investors who are looking for tradable and liquid *sukuk* and also suitable for investors who are looking for a less-risky, short term investment.

#### 4.3.7 The Procurement and Manufacturing

In the field of procurement and manufacturing, a manufacturer may sometimes need to acquire raw materials or other goods and equipment. For this purpose, a supplier may sell the necessary materials and equipment with deferred payments (using *murabaha* or *bay nasiya* facilities) to the manufacturer. Another way is by the engagement of a third party *mudarib*, who will initiate a *mudaraba* arrangement. The *mudarib* (on the basis of a *mudaraba* facility) will issue (*murabaha*) *sukuk* to the prospective investors (multiple *rabb al-mal*), who would like to engage in financing the supply of goods and equipment to the manufacturer through *murabaha* or *bay nasiya* arrangements. The *murabaha sukuk* holders will receive fixed regular payments in the short or medium term and will share with the *mudarib* the mark-up or profits arising out of the sales as per their pre-agreed equitable ratio. In principle, the *sukuk* holders will not be able to trade or exchange the *sukuk* against the cash or fixed receivables or cash flow with an excess or a discount. Therefore, as far as the issue of tradability or liquidity is concerned, *murabaha sukuk* are not suitable for investors who are looking for tradable and liquid *sukuk* but they are suitable for investors who are interested in a less-risky investment. To be tradable, the underlying asset of the *sukuk* must be non-monetary (i.e., neither cash nor fixed receivables). Another suitable financing facility for manufacturers or producers is *istisna*. As per *istisna*, the manufacturer makes goods or any type of machinery according to the specifications set out in the manufacture or purchase order of the customers (buyers), who agree to purchase and pay the price of the goods or machinery in a lump sum in advance or gradually according to manufacturing progress (on the basis of a *salam* contract). The manufacturer will issue certificates (*salam/istisna sukuk*) to the customers (buyers), who will be able to trade and exchange them.

#### 4.3.8 The Exploration and Research Projects

In cases where a person (*ja'eel*) needs to engage someone else (*a'mil*) for doing exploration or a research project in return for some compensation (*jo'l*) the arrangement is called *ji'ala*. The recompense may be a known consideration (if the engagement has a not-for-profit purpose) or a portion of the explored or discovered product (if it is done for the purposes of profit). For example, an owner of land (i.e., the House of Wealth on behalf of the public) may engage a contractor to conduct an exploration for oil or any other mineral resources. The engagement would be in return for a known recompense or a portion of the produced oil or any other mineral. The explored or discovered product would belong to the *ja'eel* and an *a'mil* would hold the explored or discovered product in trust, under custody, until its delivery to the *ja'eel*. The *a'mil* will become entitled to the recompense when he delivers the product to *ja'eel*. In a *ji'ala* arrangement, a dealer can purchase the contingent properties of the *ja'eel* or the agreed portion of *a'mil* in the contingent properties (when it is agreed that the recompense of *a'mil* will be a portion of the discovered or explored properties). The *a'mil* may in turn act as a *mudarib* and issue *ji'ala sukuk* to prospective investors who would like to engage in financing the project. The *ji'ala sukuk* holders are considered the owners of the contingent portion of the product. As per this arrangement, the *sukuk* holders are able to exchange or trade the *ji'ala sukuk*. Therefore, *ji'ala sukuk* are suitable for investors who are looking for tradable and liquid *sukuk* and also suitable for investors who are looking for a high risk but profitable investment.



## 4.4 Best Western For-Profit Practices

There are some Western modes of financing which are good enough to be adopted in the new alternative model with only some marginal changes in their structure or characteristics. Not only are these successful and widely used, but they are also largely consistent with the theory of balancism and also *Sharia* rules and objectives. These widely used best customary practices are: partnerships, joint stock companies, venture capital, mutual funds (open-end and closed-end), and private equity (funds).

### 4.4.1 Partnership

A partnership<sup>121</sup> is an association of two or more persons who enter into an agreement to carry on a business (as co-owners of the business) in which they promise to make contributions (either in the form of capital or services) in return for a share of profits including the surplus and also a share of losses.<sup>122</sup> In a *prima facie* partnership, in the absence of an agreement, partners receive neither salary,<sup>123</sup> nor commission,

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<sup>121</sup> Here, the discussion about partnership is based on the New York State “Uniform Partnership Act” (NY Partnership Law), which governs partnerships. A partnership may be set up in one of these forms: General Partnership, Limited Partnership, Registered Limited Liability Partnership (RLLP), and Limited Liability Company (LLC). Aside from general partnerships, all other partnerships also referred to as alternative unincorporated business organisations.

<sup>122</sup> The share of profit is liquid, transferrable, and the personal property of the partners. However, limited partners as with their limited right of control have limited right of liquidity i.e., their interests in the partnership are not freely transferable without the unanimous consent of all partners.

<sup>123</sup> In other words, partnership is not employment setting i.e., not about salary. This is exactly consistent with the implications of the theory applied in the thesis i.e., contribution-based distribution or balancism.

nor fixed interest<sup>124</sup> nor similar compensation. Furthermore, in a *prima facie* partnership, all partners will be entitled to equal control,<sup>125</sup> through a vote, over the partnership. The partners are categorised into either general partners or limited partners. General partners, who exercise managerial control of the business, are personally liable for all debts and obligations of the partnership. In contrast, limited partners, who may not exercise substantial managerial control of the business without forfeiting their limited liability status, have limited liability. In the case of the dissolution of the partnership, priority is given as follows: to all outside creditors, to all internal creditors, to all capital contributors, and finally if any profits remain, these are to be shared equally/proportionally among partners. In terms of the distribution rule, each partner receives their loans and capital contributions, plus their share of profits minus their share of losses (if any). Obviously, the *prima facie* modern partnership is the most similar collective investment scheme to the *musharaka* facility in Islamic law. It is well understood in Islamic finance that that the return on an investment has to be linked to the performance of the venture being invested in, and that the capital contributed must be liable to the financial risks of the venture. As such, Islamic financing has a tendency toward a “partnership” model (rather than the Western debtor-creditor model), with the capital provider and receiver sharing any profit or loss

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<sup>124</sup> In other words, the contribution of every single partner is treated as an equity interest, which is contingent, rather than an advancement of a loan with a fixed interest. This is in exact conformity with the implications of the theory applied in the thesis i.e., the interest accruing to a given contribution has to be contingent and linked to real economic activities.

<sup>125</sup> According to NY Partnership Act, with regard to share in management, it is an asset that is owned by the partnership itself, and not by the individual partners. Individual partners may not transfer their share of management/control to some third parties (e.g., a partner cannot sell his right to vote). Partnership members may control the partnership themselves, but may also delegate to third party professional managers. As per the research theory, if it is managed by one or some of the partners themselves their share has to be adjusted up to compensate it and if it is managed by third party professionals they are treated just like other partners and will be given a proportionate share according to their contribution of professional services.

in a preagreed arrangement.<sup>126</sup> That is why, it can be said that that Islamic finance is much more similar to the Uniform Partnership Act in the US than it is the UCC Article 9 provisions as to secured transactions.<sup>127</sup>

Some important adjustments to the Western partnership model are necessary in order to make it suitable as per the research theory. Every single partner has to have (unlimited) proportionate liability. The partnership, in and of itself, holds no legal personality and consequently no ownership right over the contributions of the partners.

#### **4.4.2 Joint Stock Company (JSC)**

In considering the modern practices of a joint stock company, it seems it is a hybrid of (*sharkat*) *inan* and (*sharkat*) *mudaraba* concepts as they are found in *Sharia*.<sup>128</sup> All the participants that contribute equity capital are considered shareholders (partners). In some cases, one or more of the shareholders may assume the management of the joint-stock company. The shareholders who contribute capital

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<sup>126</sup> See Frank E. Vogel and Samuel L. Hayes 'Islamic Law and Finance: Religion, Risk, and Return' (Leiden: Boston, Mass. :Brill, 2006) p. 130.

<sup>127</sup> See McKean James Evans 'The Future of Conflict between Islamic and Western Financial Systems: Profit, Principle and Pragmatism' (University of Pittsburgh Law Review, Vol. 71, Issue 4, Summer 2010) p. 824.

<sup>128</sup> Some scholars have argued that the structure of a modern joint stock company is very similar to the concept of *mudaraba* in Islamic law. They have further argued that the concept of separation of ownership and control is also found in the structure of Islamic *mudaraba*. See A. R. Abdul Rahman 'Issues in Corporate Accountability and Governance: An Islamic Perspective' (American Journal of Islamic Social Sciences, vol. 15, 1998) pp. 60-61; see also, S. W. Hasanuzzaman 'Limited Liability of Shareholders: An Islamic Perspective' (Islamic Studies, vol. 28, 1989) pp. 355-358. As per Wormser, a joint stock company is a type of business association which is considered midway between the partnership and the corporation. The truth is, however, that the modern joint stock organisation, as a result of statutory developments, includes the most of the key features of the private corporation that nowadays it is too difficult in many situations to determine precisely where the legal domain occupied by joint stock organisations begins and ends. See I. Maurice Wormser 'Legal Status of Joint Stock Associations' (Fordham Law Review, Vol. 3, Issue 1, pp. 1-10) pp. 1 and 9.

and also assume the responsibility of the management of the company play two roles: partner (*rabb al-maal/sharik*) and manager (*mudarib*).<sup>129</sup> Therefore, their contributions are in the form of both tangible (capital contribution) and also intangible (management skills). Their proportionate shares in the company are adjusted up to compensate for their intangible contribution. However, the manager of the company does not have to be a member of the tangible contributors to the company and he may be invited solely to contribute his management skills without having to contribute any tangible assets such as capital. In such situations, the third party invitee will be treated either as one of the shareholders of the company or will act merely as a *mudarib* of the company on the basis of a *mudaraba* arrangement. In general, the modern joint-stock company does not contradict the rules of *Sharia* provided that, like any other type of partnership, contributions made to the company as well as all transactions of the company dealing with third parties and also activities in which the company involved in, should be consistent with the rules and objectives of *Sharia*.

#### 4.4.3 Venture Capital (VC)

A venture capital firm is an investment and entrepreneurship firm that is most commonly identified with Californian Silicon Valley start-ups.<sup>130</sup> They have been very

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<sup>129</sup> For more see Mahmood Mohamed Sanusi 'Critical Issues on Islamic Banking, Finance and Takaful' (Kuala Lumpur, INCEIF/2010) p. 186.

<sup>130</sup> These start-up (investment or entrepreneurship) firms have a "high risk-high reward" (i.e., a larger probability of small loss against a smaller probability of large gains) nature. Empirical research has revealed that about seven percent of such start-ups in the US (between 1969-1985) yielded returns of more than ten times the invested seed capital compared to more than sixty percent of them that either lost the invested capital or generated returns less than savings account rates of return in the same period. See W. D. Bygrave and J. A. Timmons 'Venture Capital at the Crossroads' (Boston Harvard Business school, 1992) pp. 1-2, 9

successful<sup>131</sup> in introducing the most advanced technologies by investing in new research and development projects while creating a massive job market, additional tax revenue and export potential in the US and increasingly in Europe and South East Asia especially in emerging economies.<sup>132</sup> Moreover, venture capital firms respond to a great need of entrepreneurs, who are hungry for capital and are unable to raise funds from the conventional banking system or from family members or close friends. To advance loans, the conventional banks demand heavy guarantees, which are not affordable for entrepreneurs to meet and are too burdensome for family members or friends to finance the financial needs of entrepreneurs. Venture capitalists fill this vacuum (known as the MacMillan gap)<sup>133</sup> by providing the financial needs of young entrepreneurs without demanding collateral and without imposing other burdensome conditions.

According to Cronson<sup>134</sup>, a venture capital usually involves a business association, a project, or an idea which is not “bankable”. It is said that a business enterprise, whether it be a proprietorship, or corporation, or partnership or trust, has arrived at a development phase when it is “bankable”, i.e., it can receive funding through some intermediary financial agencies and tools such as banks and public offerings. This type of commercial financing facility is usually available to an enterprise with a performance

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<sup>131</sup> Very successful products of venture capital initiatives are Apple Computer, Fed Ex, and Kleiner & Perkins. The first classic venture capital, the American Research and Development Company was established in 1946 by General Doriot, who was teaching at Harvard at the time. See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar, Studies in Islamic Finance, Accounting, and Governance, 2011) pp. 249-250.

<sup>132</sup> For more detail in this regard see Matt Richtel ‘Silicon Valley Investors Lobby for Clean Fuel’ (International Herald Tribune, 30 January 2007; John Tagliabue ‘Start-ups Become Old Hat for Europeans’ (International Herald Tribune, 2006; Rebecca Buckman ‘Venture to Nowhere’ (Forbes Asia, 12 January 2009).

<sup>133</sup> See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar, Studies in Islamic Finance, Accounting, and Governance, 2011) p. 251.

<sup>134</sup> See Robert G. Cronson ‘Venture Capital Financing- Legal and Financial Considerations’ (Notre Dame Lawyer, Vol. 48, Issue 3, February 1973) pp. 614-622) p. 614.

record which signifies enough incomes or assets to attract a commercial loan and present reasonable assurance of repayment.

A classic venture capital firm, which functions as a partnership in the US, is made up of investors who are usually institutional investors, such as: pension funds,<sup>135</sup> banks, and insurance companies, and they provide capital (as limited partners) to a venture capital firm, which is operated by general partners,<sup>136</sup> in return for the acquisition of certain equity shares in the venture capital firm.<sup>137</sup> General partners of the venture capital firm use the funds in equity financing of different, diversified<sup>138</sup> and often young entrepreneurs, who have very promising and potentially lucrative business plans. The selected entrepreneur sets up a joint stock corporation (i.e., an entrepreneurial company), whose majority shares<sup>139</sup> are acquired by the venture capital firm in return for its equity finance. The profits generated from the investment cycle are shared among the limited partners and general partners of the VC according

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<sup>135</sup> In the US, the participation of pension funds in the venture capital industry was made possible in 1974, when the Employee Retirement Income Security Act (ERISA) was introduced. The Act made it possible for pension funds to invest in VCs up to 2.5 percent of their portfolio. A few years later the introduction of two more Acts i.e., Bayh-Dole Act in 1980 as well as the reduction of the Capital Gains Tax to a maximum of 28 percent caused a significant growth in the VC industry in the US. The Bayh-Dole Act made it possible for companies to have access to government-owned patents, which had been created in laboratories of the public-financed universities throughout the country. The US government or the relevant government agency transferred the ownership of the patents to the universities where the research had resulted in inventions and the universities made their contribution to the VCs by transferring (licensing) patents to entrepreneurial researchers. This regulation led to impressive results around the country.

<sup>136</sup> The contribution of the general partners to the venture capital is their professional knowledge and expertise. In return for such a contribution, the general partners get a 20-25 percent share of the venture capital.

<sup>137</sup> In other words, a venture capital transaction is neither a loan transaction nor a credit transaction but an equity finance transaction.

<sup>138</sup> The reason for forming a portfolio of entrepreneurs by the venture capital enterprise is to reduce the risk of loss. It is expected that the losses made by one entrepreneur will be off-set by the profits made by another.

<sup>139</sup> Normally, nobody other than the venture capital firm will be interested in buying the shares of this newly established enterprise. That is why the shares are bought by the VC at a very low price (because the riskier the concerned entrepreneurship, the larger the share of the enterprise given to the venture capital).

to a mutually pre-agreed ratio.<sup>140</sup> These profits are, in fact, reflected in the enhanced share value of the entrepreneurial company and the participants (venture capitalists) earn their profits and exit from the investment cycle by selling their shares at an OTC market like NASDAQ by way of an initial public offering (IPO) process or, alternatively, selling their shares to a conglomerate through an M&A process. The entire pecuniary loss<sup>141</sup> made by the entrepreneurs accrues to the venture capital enterprise and is ultimately shouldered by the participants (i.e., the venture capitalists/financiers). The loss of the entrepreneurs and the general partners of the venture capital enterprise are reflected in them being unpaid for their professional efforts and management services.<sup>142</sup>

Venture capital<sup>143</sup> can be looked at as a developed version of a *mudaraba*<sup>144</sup> scheme. As a default rule, under a *mudaraba*<sup>145</sup> contract, a *mudarib* (entrepreneur)

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<sup>140</sup> The venture capital and the relevant entrepreneurs will share the profits according to their mutually pre-agreed (equitable) ratio in their relevant *mudaraba* contracts.

<sup>141</sup> The pecuniary loss is in fact reflected in the form of worthless shares of the relevant entrepreneurial company.

<sup>142</sup> See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar, Studies in Islamic Finance, Accounting, and Governance, 2011) pp. 251-253, 256.

<sup>143</sup> Venture capital is set up just like an Islamic-based *sharkat* (partnership).

<sup>144</sup> A partnership that is set up as a result of a *mudaraba* contract does not hold a separate legal entity. All dealings with third parties will be made by the *mudarib* in his name even though the *mudarib* will have to share the results of the dealings with the capital provider (*rabb al-maal*) on a pre-agreed (equitable) ratio basis. As per Iran Commerce Code articles 116 and 220, *rabb al-maal* and *mudarib* will be jointly and severally liable to third parties. For an analysis in this regard see Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan' (Tehran: *Sharkat Sahami Intishar*, vol. 5) no. 56. *Mudaraba* (which is also called *qirad*) is, in fact, one type of *musharaka* in the Sharia. For somewhat similar but different views in this regard see Omar Shaikh 'Private Equity- Modern day *Musharaka*?' (*Islamic Finance News*, vol. 4, issue 45, 2 January 2010).

cannot assign the *mudaraba* contract to another *mudarib*, unless a *rabb al-maal* (capital provider/principal) has agreed with the assignment of a *mudariba* contract. In the case of assignment of the *mudaraba* contract (which includes a delegation of duties as well), the first *mudarib* is replaced by the new (second) *mudarib* and the first *mudarib* is released from his obligations under the *mudaraba* contract and also loses all his rights (a novation occurs). The new (second) *mudarib* will have to take all the rights and duties (of the first *mudarib*) under the original *mudaraba* arrangement. However, as a default rule, a *mudarib* may assign his rights as well as his duties (if they are impersonal) under the *mudaraba* contract to a third party (e.g., he may contract with another *mudarib*)<sup>146</sup>. In this case, the *mudarib* remains liable to the *rabb al-maal* even after delegating his duties under the (original) *mudaraba* contract.<sup>147</sup>

In an Islamic venture capital scheme, the participants i.e., equity capital providers to the venture capital enterprise cannot be the same as their classical counterparts because of the limitations imposed by *Sharia*. Even in the Islamic setting, whether an Islamic *waqf* or a *takaful* institution could be a venture capital participant remains under serious doubt. However, any business association that is consistent

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<sup>145</sup> Some Islamic scholars believe that *mudaraba* is a combination of *wakala*, *wadi'a* and *sharkat* contracts. They argue that *mudarib* is considered as *wakil* (agent) of *rabb al-maal* in order for doing transactions with his capital. To do transactions, *rabb al-maal* entrusts the required capital under a *wadi'a* contract to a *mudarib*. If there are any positive returns, they will both share the profits in a pre-agreed ratio under the *mudaraba* contract. See Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan, Musharakatha-Sulh' (Tehran: Ganj-e-Danesh, vol. 2, 7<sup>th</sup> Edition, 2007) pp. 108-109 no. 58. See also Shahid Thani 'Masalik al-Afham: Sharh bar Sharaye-e-Muhaqqiq' chap-e sangi, vol. 1/2) p.281; Muhammad Hasan Najafi a.k.a. Sahib Jawahir 'Jawahir al-Kalam: Matajir' (Najaf: chap-e surbi in 43 volumes) p. 458.

<sup>146</sup> In this case, the second *mudaraba* is considered a new independent *mudaraba* contract by and between the first *mudarib* (now a new *rabb al-maal*) and the second *mudarib*. However, it will have no effect on the original *mudaraba* contract made between the (original) *rabb al-mal* and the (first) *mudarib*.

<sup>147</sup> For some supporting evidence in this regard see Iran Civil Code articles 553-556 (especially article 554). See also Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan, Musharakatha-Sulh' (Tehran: Ganj-e-Danesh, 7<sup>th</sup> edition, vol. 2, 2007) pp. 133-134 no. 73.



with the rules of *Sharia* as well as high-net-worth private investors, who will be issued certain *mudaraba* or *muqarada* securities (*sukuk*) in return for their equity capital contributions, can participate in the equity finance of venture capital enterprise.<sup>148</sup> Another important point is that the manager (*mudarib*) of an Islamic venture capital cannot assign the *mudaraba* contract (i.e., venture capital enterprise) to entrepreneurs, unless participants (*rabb al-maals*) have agreed with the assignment. However, what can happen in an Islamic venture capital, as practised in classic venture capital projects, is not the assignment of the venture capital enterprise but only the assignment of the rights including the delegation of duties (if they are impersonal) of the *mudarib* of the venture capital to the entrepreneurs. In this case, the entrepreneur/s will be liable to the venture capital *mudarib*, who remains liable to the participants (equity capital providers). In other words, there would be no contractual relationship between the participants and entrepreneurs. Consequently, the pre-agreed profit and loss sharing ratio in each of the *mudariba* contracts (one between the participants and the *mudarib* of venture capital and the others between the

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<sup>148</sup> A very critical issue in Islamic *mudaraba*-based venture capital is the guarantee of initial equity capital of the participants especially if the participants are members of the public. In Jordan and also Malaysia this guarantee is provided by the state (the state- but neither the venture capitalist *mudarib* nor the entrepreneur/s- promises that it will redeem the *mudaraba*/*muqarada* securities at a certain time in the future). See Mahmood M. Sanusi 'Muqarada Islamic Bonds as an Alternative to Bay' al-Inah and Bay' al-Dayn Bonds: A Critical Analysis' (International Journal of Islamic Financial Services, no.2, 1999) pp. 49-52; Wan Abdul Rahim Kamil 'Introduction to Sukuk (in Ram Ratings, Malaysian Sukuk Market Handbook)' (Kuala Lumpur: Tijanimas, 2008) p.27. Despite serious *Sharia* concerns, this practice of (an independent) third party guarantee (which is often provided by the state) has been approved by the AAOIFI with its *Shari'ah* standards no.17. See Muhammad al-Bashir Muhammad Al-Amine 'Sukuk Market: Innovations and Challenges' (paper submitted at the International Conference on Islamic Capital Markets, 2008). For more on guarantees see also AAOIFI *Shari'ah* Standards no.5 on Guarantees. The major criticism against the state-financed third party guarantee is why the risk of loss of the investments of participants in venture capital enterprises has to be shouldered by the public i.e., tax-payers, who do not share in the profits generated by the venture capital enterprises. This practice is certainly in conflict with well established *Sharia* rules, such as *man-lahul-qunm-alayhil-qurm* and also *la-darara-wa-la-dirar*.

*mudarib* of the venture capital and the entrepreneurs) will not necessarily be the same and they may be in different ratios and under different terms.

Regarding the practice of venture capital in Islamic countries, it was first done in Turkey in 1993, when the “*Turkish Capital Market Board*” imposed a minimum capital requirement for the establishment of venture capital in Turkey. The imposed high capital adequacy standard prevented the viability of the venture capital industry in Turkey.<sup>149</sup> In January 2005, the government of Malaysia established the “*Malaysian Venture Capital Development Council*” to facilitate the development of the industry in Malaysia with the support of the government itself.<sup>150</sup> Despite the fact that venture capital is traditionally a private sector enterprise, the state of Malaysia itself has established some venture capital firms, such as; the Malaysia Venture Capital Management (MAVCAP), and the Malaysian Technology Development Corporation (MTDC).<sup>151</sup>

#### **4.4.4 Mutual Fund (Open-end and Closed-end)**

A mutual fund is a kind of professionally managed collective investment scheme that pools money from different types of participants to invest in variety of securities such as bonds, stocks and money-market instruments. Mutual funds, which are sometimes referred to as “investment companies” or “registered investment companies” and found in many varieties including index funds, stock funds, bond funds, and money-market funds, are normally applied only to those collective

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<sup>149</sup> See Tansu Ciller and Murat Cizakca ‘*Turk Finans Kesiminde Sorunlar ve Reform Onerileri*’ (Istanbul: ISO, 1989).

<sup>150</sup> In May 2008, the Malaysian Securities Commission issued “The Guidelines and Best Practices on Islamic Finance Venture Capital”.

<sup>151</sup> See Murat Cizakca ‘*Islamic Capitalism and Finance: Origins, Evolution, and the Future*’ (Edward Elgar, *Studies in Islamic Finance, Accounting, and Governance*, 2011) pp. 261-262.

investment vehicles that are regulated and sold to the general public. From one perspective, mutual funds are divided into two broad categories: open-end and closed-end.<sup>152</sup>

An open-end mutual fund is an investment vehicle<sup>153</sup> that continually sells new shares and redeems its shares at the request of the shareholders and invests its capital in a diversified portfolio of assets, e.g., in a diversified portfolio of securities issued by different companies. An open-end mutual fund is the predominant form of pooled investment vehicles in the US<sup>154</sup> (more assets in open-end mutual funds alone than in the depository banking system), designed for public offering to retail, i.e., non-sophisticated investors, allowing them to share economies of scale and reduce transaction costs. Equal participation in a diversified pool, daily redemptions, daily

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<sup>152</sup> For more on Mutual Funds see U.S. Securities and Exchange Commission (SEC) 'U.S. Securities and Exchange Commission Information on Mutual Funds' (Available at <http://www.sec.gov/answers/mutfund.htm>) Retrieved 28 March, 2013.

<sup>153</sup> In the UK, funds are known as collective investment schemes (CISs) governed by the Financial Services and Markets Act (FSMA) 2000. As per FSMA (section 235) "any arrangement with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income". CISs can be set up either as open or closed forms and they come in numerous legal schemes. Basically, CISs are organised either in the form of a "unit trust", an "investment company", or a "limited partnership". For more on the definition and structure of these CISs, and also governing regulations in the UK and also the EU see Jan H. Dalhuisen 'Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law' (Hart Publishing, vol. 3, 4<sup>th</sup> edition, 2010) pp. 302-304. Dalhuisen points out the differences between a "unit" in a unit trust and a "share" in a company referring to *Charles v Federal Commission of Taxation* [1954] 90 CLR 598. He also mentions the differences between limited partnership and limited liability partnership in the UK.

<sup>154</sup> For more on mutual funds in the US see Investment Company Institute (ICI) 'A Guide to Understanding Mutual Funds' Available via the Internet at [www.ici.org](http://www.ici.org). See also Investment Company Institute (ICI) 'Investment Company Fact Book 49<sup>th</sup> Edition (A Review of Trends and Activity in the Investment Company Industry)' (2009) Available via the Internet at [www.icifactbook.org](http://www.icifactbook.org). For some reforming suggestions as to mutual funds see John C. Coates IV 'Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis' Electronic copy available via the Internet at: <http://ssrn.com/abstract=1311945>, Revised December 30, 2008. In the US, mutual funds are regulated under the Investment Company Act of 1940. The primary purpose of the Act is to protect investors. Investment companies and investment managers are also regulated by the Investment Advisers Act of 1940.

valuation of fund assets, and liquid portfolio (>85%) are the key features of the open-end mutual fund. The open-end mutual fund is an open-ended investment company, because it is continuously selling shares and by law it must redeem those shares, i.e., buy back its issued stocks for their net asset value (NAV) from the relevant investors. NAV changes every day and a fair market valuation is a critically important part of the open-end mutual fund.<sup>155</sup> The open-end mutual funds industry is a very big complex industry and is available in a wide variety of investment styles (stock funds, bond funds, and alternative strategies), both domestic and international.

On a basic level, an open-end mutual fund is more compliant with the rules and objectives of *Sharia* as compared to a banking institution. Investors in open-end mutual funds, unlike depositors in the banking system, remain the owners of their contributions pro rata, and consequently, although the open-end mutual funds are professionally managed, the investors still have the right to control the professional managers. However, two major *Sharia* concerns with regard to open-end mutual funds, as with almost all other modern business associations are the issues surrounding limited liability and investment activities.

A closed-end mutual fund is a regulated investment company that issues a fixed number of shares.<sup>156</sup> The shares of a closed-end fund (CEF) are offered through underwritten initial public offerings (IPOs).<sup>157</sup> In CEFs, unlike open-end mutual funds, there are no daily redemption rights (i.e., CEFs do not have an obligation to redeem the shares). CEFs, unlike open-end mutual funds, can hold illiquid assets beyond the

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<sup>155</sup> Many mutual funds usually contract third party professionals to provide pricing (NAV) services. In the US, mutual funds have to send their NAV from 4 pm (end of the market of the NYSE) to 6 pm.

<sup>156</sup> For more on Closed-End Funds in the US see Investment Company Institute (ICI) 'A Guide to Closed-End Funds' Available via the Internet at [www.ici.org](http://www.ici.org). See also Investment Company Institute (ICI) 'Investment Company Fact Book 49<sup>th</sup> Edition (A Review of Trends and Activity in the Investment Company Industry)' (2009) Available via the Internet at [www.icifactbook.org](http://www.icifactbook.org).

<sup>157</sup> A closed-end fund does not have the stabilization features that an open-end mutual fund has.

15% limit of open-end mutual funds. The shares of CEFs are generally listed on a stock exchange (or traded in the OTC market), which is where investors are supposed to get liquidity from. However, CEFs frequently trade at a discount to their NAV.

Limited liability and investment activities are the two major *Sharia* concerns with regard to CEFs. If the limited liability rule were to be substituted with a proportionate liability standard and if they were to follow *halal* investment activities, these funds, like other types of (mutual) funds, would in principle be in conformity with *Sharia* rules and objectives.

#### **4.4.5 Private Equity (Fund)**

A private equity fund<sup>158</sup> is an asset class or equity capital (fund) consisting of equity securities in operating companies which is not listed on an official market and whose stocks/shares are not traded on a stock exchange. A private equity fund is initiated by entrepreneurs, and funded by retail and institutional investors who intend to engage in long term investments and can commit large sums of money for long periods of time. They take the exchange-listed distressed public companies, also suffering from poor management, take them private (i.e., delist them) and make a profit by way of the provision of better management in a relatively long period and

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<sup>158</sup> Mostly, private equities employ a fund structure to attract more investors to raise capital. However, private equity firms and also investment banks may make investments directly. Thus, similar to hedge fund practices, the activity itself and the conduct of it by way of funds should be distinguished. See Jan H. Dalhuisen 'Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law' (Hart Publishing, vol. 3, 4<sup>th</sup> edition, 2010) p. 313.

thereafter liquidating the companies typically through an IPO or reselling to another private firm.<sup>159</sup>

These are the essential features of a private equity. A private equity is created where its financial sponsors intend to acquire companies with a view toward improvement and eventual sale of such companies. The next essential characteristic of a private equity is “earnings before interest, taxes, depreciation, and amortisation” (“EBITDA”). For this purpose, investors of a private equity usually acquire target companies using leveraged buyouts<sup>160</sup>. Financial sponsors of a private equity also seek for a particular type of a founder or principal of the target company who will be willing of continuing to operate the company and remaining with the business and establishing a partnership with the financial sponsors of the private equity to implement its business strategy for improvement and eventual sale or public offering of the company.<sup>161</sup>

From a *Sharia* point of view, the major concern about private equities is leveraged buyout (LBO) that is conducted by many of these types of firms. By way of an LBO facility, the private equity makes use of its small assets, and those of the large

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<sup>159</sup> For an extensive and useful discussion on the law and practice of private equity in the UK and EU see Jan H. Dalhuisen ‘Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law’ (Hart Publishing, vol. 3, 4<sup>th</sup> edition, 2010) pp. 313-314. As per Dalhuisen, private equity should be distinguished from venture capital. The major difference between venture capital and private equity is that the former is used for start-ups but the latter is to take large poor-functioning, exchange-listed companies private. He points out some true concerns in private equities especially the protection of private investors against the excessive risk-taking and compensation of their investment managers. Dalhuisen calls for a carefully-focused regulation of private equity industry.

<sup>160</sup> In order to increase returns and also the number of purchased companies, private equity firms seek to borrow as much debt as possible and provide as little equity as feasible onto the capital structure of their acquisitions. That is why a private equity is heavily dependent on the nature of debt financing and also the availability of credit. See Steven M. Davidoff ‘The Failure of Private Equity’ (Southern California Law Review, Vol. 82, 2008-2009, pp. 481-545) p. 489. For more detail see also Robert P. Bartlett III ‘Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers’ (Fordham Law Review, Vol. 76, 2008).

<sup>161</sup> See Jeffrey A. Blomberg ‘Private Equity Transactions: Understanding Some Fundamental Principles’ (Business Law Today, Vol. 17, Issue 3, January/February 2008) pp. 51-52.

public target company, to raise the loans required to fund a large purchase i.e., a takeover deal. These loans are indeed interest-bearing debts that render the practice to be *rabawi* (usurious). Broadly speaking, where a private equity entrepreneur intends to subscribe an Islamic investor into its fund, it will have to consider *Sharia*-compliant investment restrictions. The important restrictions that have to be incorporated into the fund documentation are: a) no investments will be made in *haram* industries; b) no investments will be made in risk-trading or *riba*-bearing<sup>162</sup> instruments such as convertible debt securities; and, c) no participation will happen in bridge financings. The use of *riba*-based debt at both the level of portfolio company and also at the level of any financing SPV in the process of acquisition is of special concern to Islamic investors, because of the prohibition of *riba* in *Sharia*. Also, as mentioned before, investment in leverage buyout funds is evidently problematic for Islamic investors mainly due to the use of debt financing for acquisition purpose in most typical buyout arrangements. It is, though, possible to solve these problems through the creation of “Islamic debt” by employing, among other facilities, a lease financing arrangement, i.e., *ijara wa iqtina*<sup>163</sup> with regard to the assets of the portfolio

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<sup>162</sup> In Islamic finance, the return is only acceptable if the investor shoulders a risk in the financed enterprise beyond the credit risk of borrower. *Riba* prohibition will preclude the private equity fund lending or borrowing at interest, or investing in interest-based securities. In Islam, profit signifies successful entrepreneurship as well as the creation of additional wealth through the productive activities, whereas interest or usury is considered as a cost that is accrued without regarding the result of investments and may not create any wealth if there are investment losses. Social justice obliges capital providers and receivers to share rewards as well as losses proportionally and that the process of wealth creation and its distribution in the economy results in a fair, just and real economy.

<sup>163</sup> It is also called *ijara-thumma-bay* or *ijara-bisharte-tamlik*, or *ijara-wa-iqtina*, or *ijara-montahi-bitamlik*. It is a contract which begins with an *ijara* contract for the purpose of leasing the lessor’s asset to the lessee. Consequently, at the end of the lease period, the lessee will have an option to purchase the asset at an agreed price from the lessor by executing a sale/purchase (*bay*) contract.

company. Given these concerns, there have been attempts to pool Islamic investors in a separate *Sharia*-compliant vehicle in parallel with the main fund.<sup>164</sup>

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<sup>164</sup> For more detail see Marwan Al-Turki 'Sharia-Compliant Private Equity Funds: What Private Equity Mangers Need to Know' (Eurekahedge, June 2007)



## **Chapter Five:**

# **Parts Three, Four and Five of the Second Tier of the Model (3, 4, 5): Not-For-Profit and Microbusiness Tools and Facilities**

## 5.1 An Introduction to Not-For-Profit Facilities

According to article 11, paragraph 1 of the ICESCR<sup>1</sup>, “The States Parties to the present Covenant recognize the right of everyone to an adequate standard of living for himself and his family, including adequate food, clothing, and housing, and to the continuous improvement of living conditions”.<sup>2</sup> Some scholars have read this article very narrowly and limited their focus on basic material goods and essential economic rights to promote a “rudimentary degree of dignity and care for human life”. As per Khan, the reason for this limited focus is both “pragmatic” and “ideological”. Pragmatically, furnishing a certain welfare-like conditions and a particular amount of material goods require a lot of cost e.g., the “right to work” and the “right to adequate health care”. And ideologically, the purpose of limited interpretation of the article was to avoid supporting a Soviet-like socialism model in the midst of the Cold War by capitalist, First World countries like the US and UK.<sup>3</sup>

As it is suggested in the thesis, it is the responsibility of the “House of Wealth” to secure a minimum standard of living for every member of the public, rather than the state, through a just distribution of the proceeds of natural wealth resources.

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<sup>1</sup> International Covenant on Economic, Social and Cultural Rights

<sup>2</sup> See ICESCR, Jan. 3, 1976, 993U. N. T. S. 3. See also G.A. Res. 2200, UN GAOR, 21st Sess., Supp. No. 16, at 49, UN Doc. A/6316 (1976) (UN Resolution adopting the Covenant).

<sup>3</sup> See Zeshan Khan ‘International Economic Rights’ (Gonzaga Journal of International Law, Vol. 4) p. 5. See generally also Jurgen Habermas ‘The Theory of Communicative Action (translated by T. McCarthy, 1984) discussing the alienating effects of bureaucratization on people and their links to their surrounding community.

## 5.2 Part Three of the Second Tier of the Model (3): Profit-Free

### Facilities

To help the poor and financially weak to improve their situation, they have to be supported by granting and conferring on them some appropriate privileges (*imtiyazat*). In the Islamic finance context, suitable facilities that may be used for empowering them are a *qard hasana* (interest-free loan), an *a'riya* (use-free contract), and a *haq intifa* (enjoyment privilege). In a *qard hasana*, the ownership of the property subject to *qard hasana* transfers from the giver to the receiver. In *a'riya*, the property subject to *a'riya* will remain under the ownership of the giver. As for *a'riya*, in *haq intifa*, the property subject to *haq intifa* will remain under the ownership of the granting party or the public as the case may be.

#### 5.2.1 Use-Free Contract (*A'riya*)

*A'riya*<sup>4</sup> is a facility whereby a person called a *mu'eer* gives a *musta'eer* permission to derive profits free of charge from a property, which is capable of generating a profit while continuing its own existence unconverted, still belonging to the former. The ownership of the *a'riya* property remains with the *mu'eer* and the *musta'eer* would only enjoy the profits arising out of the *a'riya* property during the *a'riya* contract. A *musta'eer* is, in principle, not responsible for the depreciation in value or destruction of the *a'riya* property unless the defect is due to the negligence, or the excessive or unreasonable use of the *musta'eer*. If it is stipulated in the terms of an *a'riya* contract that a *musta'eer* assumes the responsibility for the depreciation in value or destruction of the *a'riya* property, a *musta'eer* will be held liable for all losses and damages in this

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<sup>4</sup> See Iran Civil Code articles 635-647.

regard though the defect is not attributed to the default of a *musta'eer*.<sup>5</sup> A *musta'eer* is obliged to return an *a'riya* property to a *mu'eer* upon the request of a *mu'eer*. This facility may be used for microfinance purposes, in order to empower the needy and also for the provision of working equipment and supplies for small and medium-sized enterprises.

### 5.2.2 Enjoyment Privilege (*Haq Intifa*)

*Haq intifa* (enjoyment privilege)<sup>6</sup> is used when a person is granted a privilege by the owner of a property to enjoy or derive profit from a property free of charge or to exploit a property which has no specific owner but belongs to the public as a whole.

### 5.2.3 Interest-Free Loan (*Qard Hasana*)

*Qard hasana*<sup>7</sup> is a facility whereby a person called a *muqrid* (lender) surrenders a specific portion of his property<sup>8</sup> to somebody else called a *muqtarid* (borrower). The borrower undertakes to return to the lender what is equivalent thereto with regard to quantity, kind and description, and if any difficulty occurs to give back the equivalent. The borrower will have to pay the price of the same on the day of satisfaction. All the risks associated with the ownership of the *qard hasana* property will be shouldered by the borrower simply because he becomes the owner of a *qard hasana* property upon

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<sup>5</sup> This is an exception to the general rule governing *a'riya* in Sharia. Another important exception according to Sharia is that if an *a'riya* property is either gold or silver whether coined or not coined, the *musta'eer* would be absolutely liable as to all losses and damages occurring to these *a'riya* properties though these are not attributed to the default of the *musta'eer*.

<sup>6</sup> See Iran Civil Code articles 40-54, 92.

<sup>7</sup> It means interest-free financing on the basis of mutual help. See Iran Civil Code articles 648-653.

<sup>8</sup> The property subject to *qard hasana* can be a monetary or a non-monetary asset. This is one of the major differences between *qard hasana* and modern loan structures.

taking delivery of the property. On the mutually-agreed date, a borrower must return<sup>9</sup> the equivalent of the *qard hasana* property he has received, even though the value of it may have appreciated or depreciated by the time of satisfaction. A major dilemma regarding *qard hasana* is the protection of its purchasing power against inflation, considering the ruling “*la darara wa la dirar*”<sup>10</sup> in the *Sharia* and also “*hifz al-maal*” (protection of property), which is one of the essentials of the objectives of *Sharia*, whilst at the same time avoiding *riba*. It is obvious that if the value of a *qard hasana* property (if it is money currency) is not protected against inflation its purchasing power will diminish during the passage of time. The answer to this paradox is simple. The prohibition of *riba*, which is expressly mentioned in the *Quran*, prevails over the mentioned *Sharia* rules, which are found in the *Sunnah*. A lender is never permitted to ask for any excess payments from the borrower in addition to the principal or the equivalent value of the *qard hasana* property.<sup>11</sup> A *qard hasana* facility may be used to finance the payments of overdue debts and also for the provision of the basic needs of the needy. This may also be used for microfinance purposes, to empower individuals or entrepreneurs of small or medium-sized enterprises.

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<sup>9</sup> The return of the equivalent value of a *qard hasana* property may be guaranteed by a borrower or a third party.

<sup>10</sup> Harming the rights of others (including the abusive exercise of one’s own right) is not allowed, and any losses and damages incurred by the victim because of the offence against the injured party will have to be cured.

<sup>11</sup> For other supporting evidence see Iran Civil Code article 650.

### 5.3 Part Four of the Second Tier of the Model (4): Philanthropic Facilities

Undoubtedly, in any society, there are people who are poor<sup>12</sup> or unemployed who simply cannot meet their financial needs and pay their debts because they do not have enough income and are unable to borrow money. These circumstances may require an act of charity.<sup>13</sup> Society as a whole should help these poor people through charitable giving.<sup>14</sup> According to Asutay<sup>15</sup>, an institutional framework on the basis of Islamic axioms and values such as *adalah* (justice), *tawhid* (oneness of God), *ihsan* (beneficence), *waqf* (trust-like concept), and *zakat* (tax-like notion) has to be set up in order to pursue social well-being and respond to the social and developmental needs of humanity.<sup>16</sup> His research concludes that although Islamic banks and financial institutions have unexpectedly performed very well and have even had financial success compared to their counterparts - especially during the recent financial crisis - the fact remains that this success has been at the cost of 'social and economic developmentalist' aspirations of the Islamic moral economy.<sup>17</sup> They have offered

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<sup>12</sup> The Quran recognises two types of poor people: a miskeen, who has no assets and a faqeer, who does not have enough to enjoy a decent standard of living.

<sup>13</sup> As per the Quran (2:280), in circumstances where the debtor is in a difficult situation and needs some time to repay his debts, it is strongly recommended that there be a postponement of his obligations until his situation improves and that if the creditor voluntarily discharges the debtor and writes off the debt (as almsgiving) it would be beneficial for the creditor himself.

<sup>14</sup> Some believe that, like personal lending, charity should be left to individuals. However, considering the modern world where people know each other very little, it is generally agreed that there is a need for organised charities to be set up and run across the entire society. For more discussions in this regard see A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A.S. Noordeen, 2005) pp 50, 60-62. In the Islamic economic order, there are two major concepts in this regard. One is sadaqa which is an optional charity and the other is zakat which is an obligatory alms-giving.

<sup>15</sup> See Mehmet Asutay 'Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs. the Realities of Islamic Finance' (Asian and African Area Studies vol. 11, issue 2, 2012) pp. 93-97, 110.

<sup>16</sup> I would add *daman ijtimaa'ee* (social responsibility) to the mentioned Islamic values.

<sup>17</sup> According to Asutay, the Islamic moral economy is the foundation of Islamic finance.

products focusing more on their “constructing process” and “form” rather than “substance” and “consequence”, the latter two being more important and valuable from a social development perspective.<sup>18</sup>

In an Islamic setting, an understanding of how to spend wealth<sup>19</sup> is very important. There are two ways for redistribution<sup>20</sup> of wealth to help the promotion of the public good or to help the needy: voluntary and obligatory. The former may be made in the form of a *waqf* (a voluntary endowment), a *sadaqa* (a voluntary almsgiving), an *ibra* (a voluntary waiver of debt receivables) or a *hiba* (a voluntary gift).<sup>21</sup> The latter may be performed in the form of *zakat* (obligatory tax-like duty) or *kharaj* (certain portions of the proceeds of natural wealth resources).<sup>22</sup> These two ways can play very significant roles in the alleviation of poverty in society. However, it seems there should be a kind of hierarchy in the implementation of these two ways. In other words, the obligatory institutions should only play their role if the voluntary

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<sup>18</sup> See N. Zaman and M. Asutay ‘Divergence between Aspirations and Realities of Islamic Economics: A Political Economy Approach to Bridging the Divide’ (IIUM Journal of Economics and Management, vol. 17, issue 1, 2009) pp.73-96.

<sup>19</sup> Unlike the Quran which imposes no maximum limit on wealth but strongly encourages a moderate and voluntary redistribution of the accumulated wealth preferably through voluntary means, the Bible is much harsher on wealthy Christians. For the view of Islam see the Quran (47: 36-37), and also Ibrahim Canan ‘Hadis Kuliyati Kutub-i Sitte Tercume ve Serhi’ (Ankara: Akcag, 1995) pp.176-177, 261. For the view of Christianity see Luke (6: 24) and Matthew (19: 24 and 26: 24)

<sup>20</sup> As per the Quran (59:7), the circulation of wealth among only a few rich people is strongly condemned: “Whatever (from the possessions of the people of the townships) Allah has bestowed on His Messenger i.e., the Prophet, belongs to Allah, and to the Messenger, and to his kinsfolk, and to the orphans, and to the needy, and to the wayfarer so that it may not (merely) make a circuit between the wealthy among you. So accept whatever the Prophet gives you, and refrain from whatever he forbids you, and fear Allah, for Allah is strict in punishment”.

<sup>21</sup> These four tools are the main channels for the voluntary redistribution of accumulated surplus wealth by wealthy people.

<sup>22</sup> These two instruments are the main sources of tax revenue in an Islamic state which have to be paid to the House of Wealth (and to some extent to the Treasury of State). These instruments are in fact direct taxes. It seems, there is no indirect taxation e.g., based on consumption, in the Sharia.

institutions fail to achieve their goal.<sup>23</sup> If a voluntary means for the redistribution of wealth in society by individuals themselves does not lead to a proper circulation of wealth and fails to alleviate poverty, the state should be drafted in to eradicate poverty by way of the imposition of an obligatory means. It can be said that this approach is a middle-way solution because while the private generation of wealth with no upper level is possible in this model, at the same time the involvement of the state (i.e., the House of Wealth or the House of Market Control) to alleviate poverty in society is permitted if the people fail to achieve a just and balanced circulation of wealth among themselves.

In western world, e.g., in England, charities and their modern legal forms have been developed to a large degree due to a blatantly political atmosphere. For example, the Preamble to the Statute of Charitable Uses 1601 in England was allegedly enacted to control possible social riots and constituted part of “a systematic and tight programme of Elizabethan social reform” plan. According to Dunn, charitable purposes may well date back to the 17<sup>th</sup> century, but they have not gone much beyond this lineage. Modern society, with its ever-increasing recognition and support of the rights and needs of its people, and the responsibility and accountability of institutions and those in influential situations, is based upon a history of legal and political change pushed, to some extent, by philanthropic fanaticism. Undeniably, some parts of English social welfare reform acts exist without willingful actions. From the famous philanthropists of the Victorian era to the modern supporters and reformers of the 20<sup>th</sup> century, charities have been active in evaluation of needs and responding to those

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<sup>23</sup> For a similar approach see Mabid Ali Al-jarhi and Muhammad Anas Zarqa ‘Redistributive Justice in a Developed Economy: An Islamic Perspective (Jakarta: Proceedings of the Sixth International Conference on Islamic Economics, Banking and Finance held on 21-24 November 2005, vol.1, 2006) pp.44 and 46. They argue that voluntary institutions are given a primary role and are favoured over those that are obligatory. However, as per the Quran (17-29), in making voluntary distributions the people should be neither extravagant nor miserly.



needs. In the age of completely free market, where charity began in the home and then developed to include the church and also the community, charitable acts could be viewed as political tools.<sup>24</sup>

To implement the redistribution of wealth in a more efficient way and also on a wider scale across society, appropriate philanthropic foundations with different sources of funding as well as different functions have to be set up. These foundations are those that would provide funds for: health, education, science, art or religion and the basic essential living needs of people. The philosophy of these foundations should be to promote the public good and also ad hoc assistance to any individual who is in need.

### **5.3.1 Voluntary Almsgiving (*Sadaqa*)**

*Sadaqa* is often given for personal reasons to good causes, to whomever the giver thinks suitable. Giving *sadaqa* is done regardless of the obligatory *zakat* or tax and does not count as *zakat* or part of *zakat*, which must be paid irrespective of the amount paid for the purposes of *sadaqa*. A specific organisation may be established for the collection and distribution of *sadaqa* funds.<sup>25</sup> This facility may also be used to finance the basic essential needs of newly married poor couples.

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<sup>24</sup> See Alison Dunn 'Demanding Service or Service Demand- Charities, Regulation and the Policy Process' (Modern Law Review, Vol. 71, Issue 2, March 2008) p. 247.

<sup>25</sup> In Iran, there is an organization which is responsible for collecting *sadaqa* from *sadaqa* givers and distributing it to the poor (this organization is called Komite-ye Imdad-e Imam Khomeini).

### 5.3.2 Voluntary Gift (*Hiba*)

*Hiba*<sup>26</sup> is a contract designed for when the owner of a property hands over his property at no cost to another. The donor is called a *wahib* and the recipient is a *muttahib*. The 'free' property is called a *mawhuba* (gifted asset). *Hiba* is not legally binding until after the delivery of the *mawhuba*. Sometimes, a *hiba* may be in return for some consideration by the *muttahib*. This kind of *hiba* is called a *hiba muawwada* (exchanged gift). *Hiba* is a permissive contract and may, unlike *sadaqa*, be terminated by a *wahib* if the *mawhuba* is still in the possession of the *muttahib*. A *mawhuba* can be any kind of property including financial assets. This facility may be used for the purpose of donations to relatives and close friends. This may also be used for the discharge of debt, and for settlement and compromise (*sulh*) purposes.

### 5.3.3 Waiver of Receivables (*Ibra'*)

*Ibra'*<sup>27</sup> occurs when a creditor voluntarily writes off his receivables from a debtor. The release of a bankrupt from a debt obligation is also valid. The waiving of a debt differs from waiving an asset or a property, which is called *e'rad*. The purpose of *ibra'* is for the generous disposal of assets, concession and leniency.

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<sup>26</sup> See Iran Civil Code articles 795-807.

<sup>27</sup> For more detail see Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 245-247, articles 289-291.

### 5.3.4 Voluntary Endowment (*Waqf*)

*Waqf*<sup>28</sup> or *habs* (voluntary endowment/trust-like product) is a perpetual<sup>29</sup> endowment, which occurs in the surrender or detention of a privately owned property<sup>30</sup> (*mawqufa*) in order to devote its profits to some specific good<sup>31</sup> cause, e.g., for charitable or religious purposes. In cases where the beneficiaries or the purpose of the *waqf* are specifically limited (e.g., to family members<sup>32</sup>) it is termed a “special”<sup>33</sup>

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<sup>28</sup> *Waqf* literally means to cause a thing to stop while still standing. See Iran Civil Code articles 55-91. For more detail see also Nasser Katouzian ‘Qanun Madani dar Nazm Huquq Kununi-ye Iran’ (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 60-77, articles 55-91. The closest word for *waqf* in modern finance is “trust”. A fundamental distinction between *waqf* and modern charities is that the ownership of the corpus of *waqf* property is retained forever for the *waqf* estate as a separate legal entity and never transfers to beneficiaries or anybody else. A further difference is that unlike trust instruments in common law, no type of Islamic *waqf* can be created in a revocable form. It is the resulting profits and benefits (i.e., proceeds) of the corpus of *waqf* property which are used for the designated purposes mentioned in the *waqf* deed. A beneficiary’s interest in a trust in modern terminology is considered an equitable interest and the trustee holds a legal title with regard to the trust assets. See Nasser Katouzian ‘Qanun Madani dar Nazm Huquq Kununi-ye Iran’ (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) p. 61 article 56.

<sup>29</sup> Some jurists especially from the Maliki School recognise a temporary *waqf*. They also allow the usufruct *waqf* or *waqf al-manafi* (i.e., benefits) like the *waqf* of a leased property for the term of the lease agreement. See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 81. However, by definition, perpetuity is an inherent feature of *waqf*, its form can never be a temporary one. Considering this, the usufruct *waqf* or *waqf al-manafi* is not valid for the following reasons: a) in *waqf*, the corpus (i.e., seed property) of the *waqf* from which the income is generated has to be separate from the creator of the *waqf* and transferred to a separate entity (a *waqf* estate); b) this purpose may be satisfied using another well-known concept in the Sharia i.e., “*haq intifa*” (enjoyment privilege: a privilege of exploitation whereby a person derives profit or benefit from a property whose ownership belongs to somebody else); c) as per Iran Civil Code articles 55 and 58, a *waqf* of benefits (*manfa’a*) and a *waqf* of claims (receivables) is void.

<sup>30</sup> To be a valid *waqf*, both the corpus of the *waqf* property and its benefits should undisputedly be, before the execution of *waqf*, under the possession and legal control of the creator of the *waqf*.

<sup>31</sup> A *waqf* created for an unlawful purpose is null and void.

<sup>32</sup> To preserve and avoid the fragmentation of wealth and ensure the future welfare of his family and also to alleviate poverty at the familial level, a wealthy person may set up a family *waqf* (according to Sharia) or a trust as per the modern legal system. The founder of a *waqf* may appoint himself, his offspring, or any other trustworthy person called a *mutawalli* to be in charge of managing the *waqf*.

<sup>33</sup> In case of a special *waqf* (also called a *waqf ahli* or *khas*), if all the beneficiaries of the *waqf* die it automatically becomes a public *waqf* (also called *waqf khayri*) and will be managed by the House of Wealth.

*waqf* but if they are unlimited the *waqf* is considered a “public”<sup>34</sup> *waqf*.<sup>35</sup> In cases where the beneficiaries directly utilise the endowed asset, such as a school or books, it is called a “direct” *waqf* and if the beneficiaries enjoy the benefits and revenue generated from the endowed property it is called an “indirect” *waqf*.

It is only allowed to endow an asset that can be used without detriment to its existence, and it can be movable, held in undivided shares or divided up.<sup>36</sup> The ownership of the *mawqufa*, after execution of the *waqf* deed, belongs to neither the founder of the *waqf* (*waqif*) nor the beneficiaries (*mawquf alayhim*). Its ownership remains with the *mawqufa* (*waqf* estate)<sup>37</sup> itself or with God<sup>38</sup> alone. The benefits of the corpus of the *mawqufa* (endowed property) would go to the specified beneficiaries or purposes mentioned in the endowment (*waqf*) deed.<sup>39</sup> If the *waqf* is for the interest

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<sup>34</sup> It seems that in public waqfs the income generated by the *mawqufa* (*waqf* property) should be placed in the treasury of the House of Wealth rather than the Treasury of State.

<sup>35</sup> This distinction between specific and public waqfs matters for the purpose of managing the *waqf* and also for payment of tax and zakat and any other applicable fees and duties. There are no accepted rules on whether any tax (zakat) should be imposed on the revenues generated by the *waqf* properties i.e., *mawqufat* (especially public waqfs) and if applicable, whether the collected tax/zakat will go to the treasury of the House of Wealth or the Treasury of State. Historically, this issue has been largely dependent on the fiscal status of the relevant states and *waqf*-state relations. For example, as per Cizakca, Hanafi Ottoman waqfs and Maliki Andalous Spain waqfs paid no tax/zakat duties. See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 80.

<sup>36</sup> It is believed that endowment of debt receivables, usufructs, benefits, or financial rights are void. See Iran Civil Code articles 55 and 58.

<sup>37</sup> Relying on this fact i.e., the separate legal entity of the *waqf* estate, some Islamic scholars have argued for the recognition of a juridical person or legal personality in Islamic law. See Nasser Katouzian ‘Qanun Madani dar Nazm Huquq Kununi-ye Iran’ (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 60 and 62.

<sup>38</sup> Some Islamic jurists like Abu Yusuf and Imam Muhammad from the Hanafi School believe that the ownership of the property subject to *waqf* becomes Allah’s property. See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 80.

<sup>39</sup> See Mirza Hussein Nouri a.k.a. Muhaddith Nouri ‘Mustadrak al-Wasa’eel’ (Qom, Mu’assaseye A’l-Albayt li Ihya’ al-Turath, vol. 2/18, 1408 Lunar Hijri Calendar) p.511. See also Iran Civil Code article 61.

of the *waqif* himself,<sup>40</sup> that is to say, where *waqif* designates himself the sole beneficiary or one of the beneficiaries or where the *waqif* stipulates the payment of his debt obligations out of the income of the *waqf* estate, it becomes null and void.<sup>41</sup> However, in the case of a *waqf* for the public use, if the *waqif* happens to become one of the beneficiaries of the *waqf* estate he is permitted to benefit and the *waqf* is valid.

A *waqf* is managed according to the instructions of the *waqf* deed. A trustee (*mutawalli*)<sup>42</sup> has to surrender the net profit to the beneficiaries of a *waqf* according to the terms of the *waqf* deed. Essentially, the *waqf* instrument instructs the trustee how to distribute the net profit to the beneficiaries. The trustee (*mutawalli*) has a custodial but not a possession interest with regard to the *waqf* estate. He has mere custody of the *waqf* property and an authority to use the *waqf* for the benefit of the beneficiaries. He has no possession interest, which gives a much greater scope of authority for dealing with the property than a custodial one does. It is possible that the *waqf* deed

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<sup>40</sup> Some Islamic scholars e.g., Imam Hanafi, believe that a *waqif* i.e., the creator of a *waqf* can revoke his *waqf* and he may also sell his right in the *waqf*. However, the prevalent thought, at least as per Imam Shafi'ee as well as the Shia school of thought, is that a *waqf*, once executed, is not revocable. For more details in this regard see Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 273. Given the primary purpose and the salient features of a *waqf*, the correct idea would be that the *waqf* is neither revocable by the *waqif* nor can the *waqif* sell his endowed property. Once created, a *waqif* loses his right in the endowed property in an absolute manner.

<sup>41</sup> The validity of a *waqf* which is detrimental to the *waqif*'s creditors is subject to the consent of the creditors. The insolvent or bankrupt is not allowed to execute a *waqf* on its estate.

<sup>42</sup> Whoever is appointed to manage the *waqf* estate is called a *mutawalli*. Note the difference between a *wakil* (agent) and a *mutawalli* (a concept similar to a trustee). In the former, a *wakil* acts under the control and authority of the principal (*muwakkil*), but in the latter case all powers and authority of the *waqif* (the founder of *waqf*) concerning the management of a *waqf* estate shifts to a *mutawalli* upon the execution of a *waqf* deed. That is to say, a *waqif* will lose his control over the *mutawalli* in the administration of the *waqf* estate. However, administration (including the maintenance of the estate) of the *waqf* by the *mutawalli* will be subject strictly to the terms and conditions set out by the *waqif* in the *waqf* deed called a *waqf* name/deed. For example, a *waqif* may appoint a supervisor called a *na'zir* to monitor the administration of a *waqf* estate by the *mutawalli*. After the administration authority (*mutawalli*) of the *waqf* estate is appointed by a *waqif*, thereafter a *mutawalli* will be deemed representative of the *waqf* estate but not the *waqif*. Therefore, the *waqif* would be unable to remove a *mutawalli* unilaterally after his proper appointment in the *waqf* deed.

may grant to the *mutawalli* (trustee) the power to appoint beneficiaries. These prospective beneficiaries, who are considered the objects of the power of appointment, will have contingent benefits in the estate of the *waqf*. A *waqif*<sup>43</sup> may reserve to himself the management of the affairs of the *waqf* estate, either for his lifetime or for some limited time period, and he may also appoint somebody else who either independently or in conjunction with the *waqif* (in strict compliance with the management terms and conditions laid down in the *waqf* deed) manages the *waqf* estate. In the case of a *waqf* for public purposes, if a *waqif* does not appoint an administrator or a trustee, the management of the affairs of the *waqf* estate are carried out in accordance with the views of the state (i.e., the House of Wealth). In a *waqf* for public use, the *waqf* estate may be used to finance public welfare expenses, e.g., free provision of health and education facilities, and also the provision of social security benefits. The priority in expending for public purposes is very important. The first priority is to provide the public with essential needs before spending on anything else, e.g., the expansion of nuclear power or military bases. In the case of a *waqf* for limited persons or purposes, the resulting benefits of a *waqf* will be distributed to the beneficiaries according to the terms of the deed of the *waqf* (*waqf name*).

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<sup>43</sup> A critical issue in a *waqf* is whether the state (or the House of Wealth) itself can be a creator of one. Some Islamic scholars argue for its legitimacy from the Sharia viewpoint and they mention examples of Diyanet Vakfi in Turkey, Bunyad-e Mustaz'afan in Iran. For more in this regard see Murat Cizakca 'A History of Philanthropic Foundations: The Islamic World from the Seventh Century to the Present' (Bogazici University, 2000) pp. 95, 101-102 and 158-159. It should, however, be noted that Bunyad-e Mustaz'afan in Iran is not officially considered either an agency of the state or a *waqf* institution. All *waqf* foundations in Iran are controlled by Sazman-e Awqaf wa Umur-e Kheyriyye and Bunyad-e Mustaz'afan is out of the reach of this system. Also, although Bunyad-e Mustaz'afan in Iran was primarily established to help the alleviation of poverty, it has deviated from its primary goal and instead has been converted into a giant business conglomerate forgetting its founding philosophy. However, for the purpose of the well-organised practice for the alleviation of poverty on a very large scale, some philanthropic foundations such as public *waqfs* may be established in such a way in which a state agency or non-governmental reputable organization is appointed as the *mutawalli* by the donors/founders of the *waqf* (*waqifs*).

In a *waqf*, a *waqf* deed automatically and absolutely imposes restrictions on usage and alienation of the estate of the *waqf* by the beneficiaries as well as the *mutawalli*. The corpus of the endowed property may not be disposed of or consumed but only the revenue generated either in the form of profit or rent is paid to the beneficiaries or used for the mentioned purposes.<sup>44</sup> To put it another way, *waqf* foundations should not get involved in business and investment activities, otherwise, they may fail to achieve their primary goal which is the eradication or alleviation of poverty and the build-up of human capital in society. The other reason why the *waqf* estate must not be utilised for commercial and investment purposes is that the manager of the *waqf* is, to some extent, in the position of an agent (a *wakil*) or a trustee rather than a *mudarib* (entrepreneur). The duty of the *mutawalli* is to perform the legal and administrative affairs of the *waqf* estate rather than using the *waqf* estate for the purpose of making profits. Moreover, from the viewpoint of *Sharia*, the disposal of a *waqf* estate is strictly prohibited except for very limited purposes and the disposition of the *waqf* estate for investment purposes is certainly not one of these. The disposal of a *waqf* estate in the event of it suffering damage, or the likelihood of it suffering damage, is allowed on condition that the maintenance of it is impossible, or that no one can be found to undertake the maintaining of it. It goes without saying that if the use of a *waqf* estate for investment is permitted it may result in investing without paying attention to the primary goal of the *waqf* which is to help the beneficiaries. Moreover, the loss of the estate may result through the course of business in cases where the corpus was allowed to be invested wholly. This possibility

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<sup>44</sup> In other words, a *waqf* recurs on an ongoing basis and it is a self-sufficient and perpetual entity that can provide very significant social services. There are some *waqfs* which have survived for longer than a thousand years financing works of architecture and providing important social services such as: health, research and education. See Marshall G. S. Hodgson 'The Venture of Islam' (Chicago University Press, vol. II, 1974) p.124. For more in this regard see also Daniel Crecelious 'Introduction' (Journal of the Economic and Social History of the Orient, vol. 38, no.3, 1995).

can never fall within the desires of the founder of the *waqf*. Last but not least, as per the definition of a *waqf* (i.e., the detention of the corpus of an asset and releasing its benefits),<sup>45</sup> it is very clear that “detention” (*tahbis*) means detaining the corpus of the *waqf* estate while distributing its benefits in favour of the specific purposes or for the benefit of the specified beneficiaries.

In terms of the type of endowed property, *waqfs* are created in the form of either moveable properties or immoveable properties. The essential point regarding the type of endowed property is that the corpus (i.e., original status) of the property, while generating profits, should be capable of enduring subject to the preservation and non-consumption of the corpus.<sup>46</sup> Consequently, a *waqf* of

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<sup>45</sup> *tahbis al-ayn wa tasbil al-manfa’a*

<sup>46</sup> This view is generally accepted by Imam shafi’ee as well as Abu Yusuf and Imam Muhammad (Shafi’ee school), Imam Malik (Maliki school), Imam Ahmed ibn Hanbal (Hanbali school), and by the Shia school. As per the Hanafi school (which was followed by the Ottomans), following the ruling of Imam Muhammad al-Shaybani, *waqfs* of movables are valid subject to a “generously interpreted custom”. See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) pp. 83-85.



consumables as well as cash<sup>47</sup> *waqfs* are void but the validity of a *waqf* of stocks<sup>48</sup> is arguable. A *waqf* of stocks is in fact a synthetic outcome of the modern joint-stock

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<sup>47</sup> This is in contrast to the opinion of some Islamic scholars, who argue for the legitimacy of cash (naqd) waqfs (cash endowment where corpus-cash is invested and the returns from the investment channeled to the beneficiaries). The origin of this idea (i.e., validity of a cash waqf) goes back to a fatwa issued by Imam Zufar in the 8<sup>th</sup> century which was later used by the Ottomans from the 14<sup>th</sup> century on. See Hamid Donduren 'Gunumuzde Wakif Meseleleri' (Istanbul: Erkam 1998) p.95. Also, invoking *hifz al-nasl* (protection of generations) which is considered to be one of the essentials of *Maqasid al-Sharia*, they believe that a wealthy person may establish a familial cash waqf for the benefit of his children or his other relatives. They further argue that the cash amounts of cash waqf may be deposited with an Islamic bank. As per their other argument (invoking *hifz al-mal* - protection of property which is considered to be another essential of *Maqasid al-Sharia*), the Islamic bank must not only guarantee the deposits but it must also guarantee the inflation premium because the purchasing power of the cash diminishes in the long run. See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 243. However, it seems this argument is not valid for a number of reasons: a) assets that are deposited with a bank on the basis of *wadi'a* cannot be guaranteed by the bank, otherwise it will no longer be a valid *wadi'a* (for a similar argument see Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 413-414 & 417, articles 607 & 614); b) any payment in addition to the deposit amount is *riba*; and c) the endowed property in waqfs cannot be in cash because it is not capable of being endured while benefiting it. For a supporting evidence with regard to the invalidity of cash waqfs see Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 60 and 62, articles 55 and 58.

corporations and cash *waqfs*. Having reformed their *waqf* laws, some jurisdictions have adopted both cash *waqfs* and *waqf* of stocks.<sup>49</sup>

The use of a *waqf* in early Islamic society, where religious ethics were highly respected by Muslims, brought about a lot of facilities for social life, in particular for those who were in need of charity or funds to cover their education costs.<sup>50</sup>

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<sup>48</sup> Regarding the validity of waqf of stocks, it is said that the validity of waqf of stocks is deduced from the following fatwas. As per the Sunni's position: a) at the beginning of 20<sup>th</sup> century, Suhrawardy, a leading Muslim jurist asked for a fatwa by the Mufti of Egypt, who answered that "specific recognised practice" (*urf khass*) can be validly taken into consideration and can be enforced. A specific recognised practice at the time was the medieval European Permanently Funded Public Debt, which was used by Muslims as a tool (i.e., corpus) of waqf capital; b) the fatwa (answer) of the Mufti of Alexandria, Muhammad Bakhit al-Muti'i, to the same question referred to the "Imam Muhammad's permission regarding the waqf of movables in an unrestricted way"; and also relying on the opinion of Sarakhsi in his book *Mabsut* who gives custom an important consideration. Regarding the Shia's position, it is referred to a fatwa given by Sheikh Abdullah al-Mazandarani in 1907 and on this basis it is argued for the validity of the waqf of stocks even through using the shares of a joint-stock company. It seems like the Mufti of Egypt, Mazandarani considered stocks in a joint-stock company as a *musha'* – "an undivided up" property, which can be endowed (as it is also permitted according to Iran Civil Code article 58). *Musha'* is used for an undivided property, which is shared among the various owners. However, some may argue that since the endowed property must be privately owned before a waqf, therefore the waqf of a *musha'* property is not valid. Furthermore, they may argue that the true scope and boundaries of a *musha'* property are not known and to avoid these problems the *musha'* property must first be divided up before it being endowed in the form of a waqf. For a somewhat similar discussion see Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) in his discussion on the institution of waqf. Since the non-negotiability of the endowed stock may cause hardship to other stockholders, I would argue for the validity of the waqf of stocks provided that the relevant company or business partnership is an open-end entity and is also established in perpetuity but not for a limited time period.

<sup>49</sup> A considerable development in the waqf legal system is the Turkish 13 July 1967 Law, which has been amended several times. One of the important improvements in this waqf Law was the tax exemption of the waqfs where at least 80 percent of the waqf revenues were spent for public purposes (this grant, albeit, was subject to the approval of the Council of Ministers). Other significant developments in waqf institutions are those established by the Johor Corporation in Malaysia (a quasi-waqf of stocks in 2005) and also the Mannan model of waqfs, which was established in Bangladesh by the Social Investment Bank (a three-sector banking institution and in fact a synthesis of the Western corporation with microfinance as well as cash waqfs) in 1995 where the Bank introduced the cash waqf certificate as a financial tool in 1997. See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) pp. 101-102, 108, 109, and 114.

### 5.3.5 Obligatory Tax-Like Duty (*Zakat*)

*Zakat*<sup>51</sup> is an obligatory payment should the total wealth of a person go above a certain threshold called a *nisab*, i.e., a surplus of his basic needs that have stayed in his possession for a whole year.<sup>52</sup> In other words, *zakat* is applied only to people with a certain enough wealth<sup>53</sup> and it has a 'permanent and stable nature'.<sup>54</sup> In terms of the legal importance of *zakat*, some scholars believe that property rights are only valid in a post-*zakat* environment, i.e., one acquires the protection of law to enforce a property right only after payment of *zakat*.<sup>55</sup> Surprisingly, in practice, in most Islamic countries *zakat* is not collected by the state and is not treated as a compulsory payment.<sup>56</sup>

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<sup>50</sup> See Muhammad Ja'far Jafari Langroodi 'Maktabhaye Huquqi dar Huquq-e Islam' (Tehran: Ganj-e Danesh, 3<sup>rd</sup> edition) p. 326.

<sup>51</sup> Zakat is known as the third pillar of Islam and it is believed that it purifies wealth and souls.

<sup>52</sup> See [http://islam1.org/iar/imam/archives/2004/12/30/zakatulmal\\_zakat.php](http://islam1.org/iar/imam/archives/2004/12/30/zakatulmal_zakat.php). As per zakat rules, if a person cannot spend his accumulated wealth within a year he would have to pay the due zakat. To avoid paying zakat, he cannot keep his assets idle and he would have to consume them to the extent of his needs and then (considering the diminishing marginal utility of the consumption) circulate the excess for charity and philanthropy purposes or to increase his wealth even further using a legitimate manner of generating income e.g., investing in a business partnership but not purchasing fixed income yielding financial products like bonds due to the prohibition of *riba*.

<sup>53</sup> As per the Quran (13:26) "every single human being should know that he has accumulated wealth not only by his own efforts but also as a result of the Creator's blessings. Allah does enlarge the livelihood and gives sustenance to whomsoever He wills abundantly and grants others in strict measure".

<sup>54</sup> See [http://islam1.org/iar/imam/archives/2004/12/30/zakatulmal\\_zakat.php](http://islam1.org/iar/imam/archives/2004/12/30/zakatulmal_zakat.php)

<sup>55</sup> See Murphy Liam and Thomas Nagel "The Myth of Ownership: Taxes and Justice" (Oxford: Oxford University Press, 2002). See also Salman Ahmed Shaikh 'Sources of Public Finance in an Islamic Economy' (Islamic Economics Project, 2010) Available via the Internet at MPRA <http://mpra.ub.uni-muenchen.de/22998>

<sup>56</sup> See Russell Powell 'Zakat: Drawing Insights for Legal Theory and Economic Policy from Islamic Jurisprudence' (February 28, 2009) Available via the Internet at SSRN <http://ssrn.com/abstract=1351024>. See also Salman Ahmed Shaikh 'Sources of Public Finance in an Islamic Economy' (Islamic Economics Project, 2010) Available at MPRA: <http://mpra.ub.uni-muenchen.de/22998>

The objective of the *zakat* system is to take away a part of the wealth of the rich and redistribute it among the eight categories mentioned in the *Quran*.<sup>57</sup> *Zakat* collected funds may be used for the purposes of public finance, e.g., the payment of the salary of civil servants responsible for the collection of *zakat*, and public defence and security purposes and also public welfare, e.g., the construction of infrastructure and provision of education, healthcare and religious facilities.<sup>58</sup> This may also be used for the payment of overdue debts of people who are unable to clear their debts. It may also be used for the provision of the basic needs of poor people. Furthermore, this may be used for the payment of holiday and transport costs of poor people.

In terms of the rate of *zakat*, it is generally 2.5 percent of wealth over a particular threshold (*nisab*). The threshold is 200 dirham<sup>59</sup> of silver or 20 dinar<sup>60</sup> of gold.<sup>61</sup> Despite the fact that the rate of *zakat* is in general 2.5 percent, especially in the commercial industry, this rate may vary in different sectors. It is believed that the rate in the agricultural industry is *ushr* (i.e., 10 percent) if the land is irrigated naturally and 5 percent if it is irrigated using the farmer's labour.<sup>62</sup> For its economic implications, there have been strong criticisms about the heavy rate imposed on the agriculture section compared to the much smaller rate for commercial industry. This criticism can be countered by stating that the rate applied as *zakat* in the agriculture industry is not

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<sup>57</sup> As discussed in the research theory, the underlying rationale for the imposition of *zakat* could be that the society as a whole is almost always one of the contributors to any economic and business activities and the society should therefore benefit from the outcome of these activities. The share of the society is indeed compensated in the form of *zakat*.

<sup>58</sup> That is why a certain portion of the collected *zakat* should go to the House of Wealth to spend for the public welfare and the other portion go to the Treasury of State to cover the expenditures e.g., for the salary payments of the civil servants, protection of borders, international foreign affairs, public defence and public security purposes.

<sup>59</sup> In terms of silver, with one dirham equal to 2.975 grams, the *nisab* is 595 grams of silver.

<sup>60</sup> In terms of gold, with one dinar equal to 4.25 grams, the *nisab* is 85 grams of gold.

<sup>61</sup> Since, at the present time, the pure content of silver and gold coins is not certain, the calculations should be conducted in a very careful manner.

<sup>62</sup> As per the research theory, the owner of the natural wealth, including land, is the public as a whole. The House of Wealth acts on behalf of the public.

*zakat* but is in fact *kharaj* (a certain portion of the proceeds of the land) levied on the land.<sup>63</sup> This will be discussed later. With regard to the mining industry, the *zakat* rate (which is again *kharaj* not *zakat*) is not specifically known in *Sharia*<sup>64</sup> and it seems the rate is determined by the state (i.e., the House of Wealth) and may vary for different mines considering their different conditions. As per the Hanafi school of thought, the *zakat* rate on mines is 20 percent,<sup>65</sup> while for the Hanbali, Maliki, and Shafiee this rate is the standard 2.5 percent. However, it is said that some Maliki jurists, likewise the Hanafi school, have argued for the rate of 20 percent on mines whose exploitation requires little effort, and the standard rate of 2.5 percent on mines that require a lot more work.<sup>66</sup> Again, it seems that the rate applied as *zakat* on mines is not *zakat* but is indeed *kharaj* duty levied on the land under which the minerals are found.

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<sup>63</sup> As per the research theory, as discussed earlier, an absent owner of the property disposes his ownership right voluntarily or by his consent in return for some value or free of charge; *sa'y* (contribution) is the only cause and underlying rationale for the acquisition of ownership. Since no human being has made a *sa'y* (contribution) to the creation of the land (just as with other natural resources), no private land ownership is allowed. The Creator has bestowed the ownership of lands to all human beings as a whole. So, any human being using any part of land privately or exclusively has to pay some value (or to make some contribution) called *kharaj* to the public (the House of Wealth) in return for the (subordinated) ownership interest of the public as a whole in the land. The primary ownership of the lands (similar to any other natural resources) remains always with the Creator (God).

<sup>64</sup> As per the Quran (2:267) "O Believers, expend in Allah's Way the best portion of the wealth you have earned and of that We have (i.e., Allah has) produced for you from the earth"

<sup>65</sup> It is said that the reason given by the Hanafi School for this very high rate on mines is by way of *qiyas* reasoning (i.e., a juristic analogy method). They have considered mining as similar to a buried treasury (i.e., *rikaz*), where it is argued that the Prophet imposed *khums* (i.e., one-fifth). See H. Inalcik 'Cizya (Islam Ansiklopedisi)' (Istanbul: ISAM, 1993).

<sup>66</sup> See Mehmet Erkal 'Islam'in Erken Doneminde Uygulamalari' (Istanbul: ISAM, 2009) p. 162.

Muslim scholars are divided on the issue of whether any tax beyond *zakat*<sup>67</sup> can be levied. There are some Muslim scholars who have argued that taxes other than *zakat* can be levied for running the operations of the state and it is not the function of *zakat* to fulfil that fiscal purpose. They have provided that *zakat* is a religious duty and is not a substitute for tax. As per these scholars, taxes other than *zakat* can be applied in an Islamic economy if these taxes are determined by the legislative council and used for public welfare.<sup>68</sup> As per Yousri,<sup>69</sup> in the contemporary Islamic economy *zakat* continues to be a fundamental tax and other taxes that are levied should be guided by the principles of *zakat* system. However, in contrast, there are some other Islamic experts who believe that *zakat* is, in principle, a substitute for tax in an Islamic economy and is the only tax that can be levied, albeit other than some casual fees,

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<sup>67</sup> As per the Quran (9:29) “Those who do not believe in Allah and the Last Day ... and who do not follow the true religion ... (have to) pay tribute [called jizya] out of their hand”. Some may argue that jizya duty is a substitute for *zakat* imposed on non-Muslims in an Islamic state for the protection of their lives and property rights. It may be further argued that the philosophy of this duty is different from that of *zakat*, which is imposed on Muslims mainly because of the rights of the poor and needy over each Muslim’s wealth. It is said that jizya was imposed for the first time by the Prophet at the rate of one gold dinar weighed roughly 4.25 grams of gold per annum. For more on jizya see H. Inalcik ‘Cizya (Islam Ansiklopedisi)’ (Istanbul: ISAM, 1993). See also Mehmet Erkal ‘Islam’in Erken Doneminde Uygulamaları’ (Istanbul: ISAM, 2009) p.132. However, in addition to practical considerations and the rule of equal treatment which is an essential part of social justice, it would be just and fair if the exact same rate of *zakat* as a substitute of jizya (under the title of *zakat*/tax) were imposed on non-Muslims.

<sup>68</sup> See Sayyid Abul A'la Maududi ‘Ma’ashiyat-e Islam [Economic System of Islam]’ (Lahore: Islamic Publications, 1970) Cited by Salman Ahmed Shaikh ‘Sources of Public Finance in an Islamic Economy’ (Islamic Economics Project, 2010) Available via the Internet at MPRA <http://mpra.ub.uni-muenchen.de/22998>

<sup>69</sup> See Abdel-Rahman Yousri ‘Public Finance: The role of taxation, expenditure and debt in an Islamic economy’ (The World Bank Group: The series “Introduction to Islamic Economics” held and sponsored by the Islamic Development Bank’s Islamic Research and Training Institute (IRTI), 2007).

charges, and duties in return for the provision of some public services and goods.<sup>70</sup> Following this line, some scholars tracing the history of Islamic public finance have opined that early Islamic rulers levied no tax other than *zakat* even when they were aware of the taxes collected by neighbouring non-Muslim states on their citizens. Some scholars have pointed to a number of compelling reasons why the government cannot levy any tax other than *zakat*.<sup>71</sup> It seems the levy of any tax-like duty beyond *zakat* should be strictly limited to circumstances where the state has a budget deficit or for the purpose of satisfying sovereign debts approved by the elected representatives of the public.

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<sup>70</sup> See Salman Ahmed Shaikh 'Sources of Public Finance in an Islamic Economy' (Islamic Economics Project, 2010) Available via the Internet at MPRA: <http://mpa.ub.uni-muenchen.de/22998>. The following could be, more or less, substantial non-zakat revenues for an Islamic economy: a) charging "service or performance based fees or duties" on the provision of public services and goods such as utilities (because voluntary payments in this regard are economically inefficient); b) levying "stamp duty" on documents so that they become legally enforceable; c) levying "toll tax" on using the development and infrastructure projects like roads and bridges; d) charging a "licensing fee" on industrialists, being active in specifically-tailored zones for some special industries and export activities; e) levying "excise tax" on activities and operations creating negative externalities to the natural environment; f) earning a "tax increment", which is a tool to use future gains in taxes to finance current public improvement projects such as bridges, recreational facilities, or toxic waste cleanup which often causes an increase in the value of surrounding real estate and new investment. This tool is widely used in Europe and the U.S. For more in this regard see Craig L. Johnson and Joyce Y. Man 'Tax Increment Financing and Economic Development: Uses, Structures, and Impacts' (New York: State University of New York Press, SUNY Series in Public Administration, 2001); g) revenues derived from some income-creating activities of government (i.e., the House of Wealth) owned enterprises (GOEs) such as the telecommunications industry, postal services industry, aviation industry which they likely face "inelastic demand" and also have considerable effect for "economies of scale and economies of scope". Running these types of GOEs may significantly help to reduce the budget deficit of a government; h) fines and penalties imposed by the House of Market Control for the enforcement of laws and regulations.

<sup>71</sup> See Monzer Kahf 'The Early Islamic Public Revenue System (Lessons and Implications)' (Jeddah: IRTI, 1987). See also Shehzad Saleem 'Islamic Concept of Taxation' (Renaissance, vol. 2, Issue 10, 1992).

### 5.3.6 Levy in Return for the Use of Natural Resources (*Kharaj*)

*Kharaj* is determined and imposed by the House of Wealth on the use of natural resources (i.e., primary wealth) especially the use of land, which belongs to the public as a whole. The amount of *kharaj*, unlike *zakat*, is not permanently fixed and its amount depends on the productivity, size, and location of the natural resource. Usually, in cases where the amount of *kharaj* is a portion or percentage of the proceeds generated out of the natural resource (especially land) it is called *kharaj al-muqasama* and if it is a fixed amount of value not linked to the proceeds of the resource it is called *kharaj al-muwazzafa*.<sup>72</sup> The collected *kharaj*, like a certain portion of *zakat*, is placed in the treasury of the House of Wealth (not the Treasury of State) and is used for the public good, such as: public utilities, hospitals, and schools.

## 5.4 Part Five of the Second Tier of the Model (5): Microfinance Facilities

The alleviation of poverty through helping the poor to obtain their economic independence and taking care of themselves is an integral part of any successful economic development programme aiming to achieve a social balance target. The provision of basic needs such as: housing, healthcare, education, and basic infrastructure has to be met in principle by profit-free and philanthropic facilities but the transmission from the not-for-profit stage (i.e., bondage and dependence) to for-profit (i.e., self-reliance and independence) requires some other powerful mechanisms.

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<sup>72</sup> See the Quran (23: 72), (18: 94), and (2:67). For more detail see Mehmet Erkal "İslam'ın Erken Doneminde Uygulamaları" (İstanbul: ISAM, 2009) pp. 195-227.



The phenomenon of microfinance is not only concerned with giving capital to the poor, but also follows the objective of increasing their human capabilities in ways that are consistent with a new thinking and ever-increasing focus on improved development objectives. The rationale for establishment of microfinance institutions<sup>73</sup> is not only to provide capital to the poor, but also is to change the very cultural practices that are damaging to their development.<sup>74</sup> In other words, these microfinance organizations adopt complementary initiatives and are not purely standalone finance institutions with a single focus on credit, financial efficiency, and financial performance.<sup>75</sup>

Microbusiness cooperatives (*ta'awun*) are the best and most efficient way to empower the poor. They are established for microfinance and microentrepreneurship purposes at a collective level, though individual microbusinesses should also be supported by the system. Poor individuals have to get together and engage in different cooperative schemes with different fields of activity considering the potential capabilities and talents of the cooperative members. These cooperatives will be run by small communities where the members are known to each other and trustworthy. The cooperatives are basically considered to be not-for-profit organisations and therefore the loans provided to the cooperative members will be interest-free loans (*qard*

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<sup>73</sup> For different types of microfinance institutions see generally Roy Mersland et al. 'The Effect of Religion in Development Efforts- Evidence from the Microfinance Industry and a Research Agenda' (2011) p. 6, available at <http://www.rug.nl/gsg/Research/Conferences/EUmicrofinconf2011/PapersI> (under "Panel 9 Microfinance and NGOs" click on "Roy Mersland [Doc]") (addressing different microfinance institutions).

<sup>74</sup> See Lan Cao 'Rethinking Microfinance' (University of Pennsylvania Journal of International Law, Vol. 33, Issue 4, Summer 2012) pp. 972-973.

<sup>75</sup> See Norman MacIsaac 'The Role of Microcredit in Poverty Reduction and Promoting Gender Equity' (Strategic Policy and Planning Division, Asia Branch, Canadian International Development Agency "CIDA", 1997) p. 19 ("Pressures to emphasize financial performance may lead to further exclusion of the poorest. Smaller loans are preferred by the poorest borrowers, but are also more costly to administer. Ultimately, the push for financial performance creates incentives for programs to increasingly filter out those at greatest risk of default and delinquency").

*hasana*). The purpose is to serve the economic needs of the community members in a collective and mutual manner. If a member has to borrow, he has to do so with the intention of paying it back at the agreed time. Some scholars<sup>76</sup> have argued that these cooperatives are kinds of mutual funds where a lender at one time may become a borrower at another. As it is clear, the establishment of small communities as described above can greatly help to foster a spirit of cooperation (*ta'awun*)<sup>77</sup> in the society and also enhance human well-being and social welfare.

## **5.5 Applications of Alternative Profit-Free, Philanthropic, and Microfinance Facilities**

The following are the major financing alternatives for not-for-profit and microbusiness activities.

### **5.5.1 The Government/Public Expenditure and Non-Income-Creating Activities**

*Zakat*, *kharaj*,<sup>78</sup> *waqf a'mm* (public endowments), and *hiba a'mm* (public donations or gifted contributions) are the main sources of funding state/public

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<sup>76</sup> See A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A.S. Noordeen, 2005) p. 46.

<sup>77</sup> See the Quran (5:2).

<sup>78</sup> Interestingly, very similar to the effect of the implementation of the *kharaj* system, as per Yu-Hung, by way of implementation of public land leasehold system, the Hong Kong government successfully gained about 39 percent of the increments of land value occurring in the 1970s and 1980s. More importantly, this captured value plus other land-related earnings constituted on average 79 percent of the required infrastructure investment per annum in the same period of time. These findings indicate how a public land-leasing system can be an important source of public funds. See Yu-Hung Hong and Alven H.S. Lam 'Opportunities and Risks of Capturing Land Values under Hong Kong's Leasehold System' (MA: Cambridge, Lincoln Institute of Land Policy, Working Paper, November 1998).

expenditure and non-income creating projects,<sup>79</sup> such as: schools, universities, hospitals, and religious centres.<sup>80</sup> Very significant government expenditures include paying government debts and providing for public defence and security. For this purpose, the government may borrow from the House of Wealth. The government may also (together with the approval of the House of Wealth or the House of Market Control) impose and collect taxes, imposts and excises. Despite these usual revenues, any state at any time may still suffer a budget deficit and consequently need extra funds to finance its expenses. The conventional means used to address this budget problem is to impose extra taxes, reduce the public expenditure, or borrow from the domestic or international debt markets. The problem linked to extra taxation is that, at

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<sup>79</sup> As per Haque and Mirakhor, public (government) expenditures are classified into: asset-creating and non-asset-creating. Non-asset-creating activities can be financed through tax revenues i.e., zakat; but, in asset-creating activities, equity modes of financing by way of issuing securities (i.e., sukuk instruments) can be used. See Nadeem Ul Haque and Abbas Mirakhor 'The Design of Instruments for Government Finance in an Islamic Economy' (IMF Working Papers 98/54, International Monetary Fund, 1998).

<sup>80</sup> For more in this regard see Salman Ahmed Shaikh "Sources of Public Finance in an Islamic Economy' (Islamic Economics Project, 17 April, 2010) p. 6. An inherent problem concerning zakat (wealth tax) is that some may argue that the imposition of zakat would usually cause capital flight and the departure of the wealthiest taxpayers to more wealth-friendly jurisdictions. This concern may be addressed by the fact that, in case of any conflict, just and fair distribution of wealth prevails over efficiency rules in the Islamic economy. In modern terms, as per the research theory, the rules of public welfare economics are preferred over the implications of a growth economics approach.

least in an Islamic state, legitimate tax sources are limited<sup>81</sup> and they are generally limited to *zakat* and *kharaj*. The concern linked to the budget cut is that any state is in principle obliged to provide essential public services, e.g., public security and the payment of the salary of civil servants and may not avoid these basic needs. The problem for public borrowing is the prohibition of usury (*riba*) according to *Sharia*. With regard to borrowing from international debt markets, regardless of the problem of prohibition of interest (*riba*), it could weaken or even destroy the independence of the state. As said above, it seems the best and most proper scenario is to borrow from the House of Wealth using a *qard hasana* facility. The other way is by collecting duties in advance, especially *kharaj* and *zakat* (albeit, with the approval of the House of Wealth) and also using some sort of *mua'wada* (tax swap/exchange) or other similar facility.

Regarding the collection of tax (mainly *zakat*, *kharaj* or other similar public or state duties), they may be collected either directly by state tax officials or indirectly

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<sup>81</sup> Any extra taxation going beyond the legitimate tax sources and also the legitimate limits is considered forbidden due to the appropriation of the property of others in an illegitimate and unjust manner. See Monzer Kahf 'Taxation Policy in an Islamic Economy (in M. A. Gulaid and M. A. Abdullah (eds)-Readings in Public Finance in Islam' (Jeddah: IDB/IRTI, 1995) p.118. The extra taxation by the state (or the House of Wealth) may also be in sharp contrast to the state duty of "hifz al-mal" (protection of the property), which is one of the essential objectives of the *Sharia* (Maqasid al-*Sharia*). However, the performance fees, service charges, and indirect taxes on trade such as tolls and market fees are considered legitimate. For some discussions concerning indirect taxes see Wantje Fritschy 'Indirect Taxes and Public Debt in the World of Islam Before 1800 (in S. Cavaciocchi (ed.), XXXIX Settimana di Studi, La Fiscalita nell'economia europea secc. XIII-XVIII)' (Florence: University of Florence Press, 2008) pp. 51-75. The Maliki school has permitted the imposition of extra taxes in some circumstances e.g., in the time of war to meet the inevitable needs of defense and security. They should be, however, imposed temporarily and levied only on the rich. In any case, these extra taxes cannot go beyond the genuine and legitimate needs of the state and the society as whole. See Monzer Kahf 'Taxation Policy in an Islamic Economy (in M. A. Gulaid and M. A. Abdullah (eds)-Readings in Public Finance in Islam' (Jeddah: IDB/IRTI, 1995) p.119-122. As per Kahf, there are seven legitimate tax sources: "kharaj, jizya, revenue of public enterprises, fees and voluntary contributions, equity finance, and public debt". To legitimise the extra taxes in an Islamic economy, some may base their reasons on *maslaha* (public interest) and *darurah/necessity* (al-darurat tubih al-mahdurat) according to the Quran (6:145- 2:173- 6:119- 5:3).

through non-governmental/non-public intermediary institutions. Indirect collection of tax by non-state institutions may be carried out using *ji'ala* (in the form of some reward for tax collection service), *ijara* (in the form of a certain fee for tax collection service), *wakala* (in the form of an agency arrangement), *bay* (sale), *hiwala* (assignment) or *mua'wada* (in the form of the exchange of a certain tax source in return for a cash payment or some other liquid asset).

Historic practices of indirect tax collection are *iqta'*, *iltizam*, *malikane*, and *esham*. Under the *iqta'* system, which was practised in several different forms, an individual or partnership was delegated or granted a privilege or right to collect tax/*zakat* from the specific tax sources (called *muqata'a*) in return for a specific reward or against a specific cash payment to the state. The basic form of this system was invented and practised first in the Sassanid and Roman empires.<sup>82</sup> A variant of this system was one that was widely practised in Egypt. This system was known as a “system of auctioning” or *iqta' al-qabala*. The individual or partnership that made a successful bid in a very competitive auction was awarded a right to collect taxes from specific tax sources for a certain time period in return for cash payments to the state.<sup>83</sup> The medieval Egyptian *iqta' al-qabala* practice was followed by one used by the Ottomans with further improvements under the label of the *iltizam* system. As for its precedent, the risk-taking highest bidder called a *multazim* was awarded a right or privilege to collect taxes from specific tax sources called “tax farms”<sup>84</sup>. Under the *iltizam* system the *multazim* (a non-state enterprise) collected taxes from the specific

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<sup>82</sup> See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) pp. 57-58. In his book, Cizakca discusses *Iqta'*, *Iltizam*, *Malikane*, and *Esham* in great detail.

<sup>83</sup> For more in this regard see Kosei Morimoto ‘Fiscal Administration of Egypt in the Early Islamic Period’ (Kyoto: Dohosha, 1981) p. 232.

<sup>84</sup> Each tax farm was divided into 24 shares, which was called *qirat*. A share (*qirat*) or a number of shares (*qirats*) could be obtained by a single *multazim* or a partnership of several *multazims*.

sources on behalf of the Ottoman state with the result that no public borrowing was necessary there. Whatever was collected by the *multazim* transferred to the state in return for a certain award to the *multazim*. The first step towards public borrowing occurred from the use of the *malikane* system where the state sold a specific tax source to the highest bidder who controlled the entire tax income of that tax source for their lifetime in return for a lump sum payment at the time of auction and also annual payments for its duration. The private enterprise was entitled to transfer his *malikane* rights in the tax farm to third parties but only during their lifetime. This public borrowing was further improved through the use of the *esham* system whereby the entire contingent tax revenues of a tax farm were divided into a number of shares (*sehm*) and they were sold to investors who continued to receive annual payments for their lifetime. In other words, in the *esham* system, the annual revenues yielded by a tax source were divided into *esham*/shares and were sold to private investors who received annuities for their lifetime in return for a lump sum payment to the state.<sup>85</sup>

An important question that may come to the mind of an Islamic scholar is whether public borrowing securitisation where the underlying asset is tax income profits from a specific tax source is usurious or not. A transaction is considered a usurious transaction (i.e., an interest-bearing transaction) where there is a stipulation in the loan agreement made for a certain time period that a certain surplus over the loan capital will be returned to the lender.<sup>86</sup> It may be argued that some of these elements are missing in the above mentioned tax collection and public borrowing arrangements. The *iltizam* system could be implemented based on a *ji'ala* (reward) contract and therefore cannot be considered a usurious transaction. Indeed, the

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<sup>85</sup> This is to some extent similar to the modern retirement pension plan whereby after having paid all due contributions to the pension fund and also having retired the person continues to receive guaranteed annuities for the rest of his life.

<sup>86</sup> For another definition see Abd al Mun'im Mahmud Al Qusi 'Riba, Islamic Law and Interest' (Temple University PhD Dissertation, 1981-1982) p. 122.

*malikane* and *esham* systems were privatised entrepreneurial activities rather than not-for-profit practices. The auction price that had to be paid to the state was determined at the time of agreement but the amount of consideration for the investors, that is, tax income generated from the specific tax sources, was not certain but contingent at the time of agreement and it could go beyond the auction price or below it. In case the tax farms generated more tax income the investors made a profit, but if they did not yield enough income the investors made a loss. Also, the agreement was made for the lifespan of the investors and thus the duration of the contract was not fixed. It seems the arguments here may go both ways as to the legitimacy of the systems. However, it seems true to say that these systems are not usurious. The first reason is that contingent revenue (arising out of specific tax sources) is exchanged on the basis of a *mua'wada* against specific cash and this dealing is not usurious in the least. Also, considering the *Sharia* rule, "originality of the validity of every transaction"<sup>87</sup>, the conclusion may go in favour of the legitimacy of the above systems. Furthermore, these systems are absolutely legitimate if the scope of auction includes not only the income generated from *zakat*/tax sources but also the natural resources whose utilisation is subject to *kharaj*. Moreover, some may argue for the legitimacy of both the *malikane* and *esham* arrangements on the basis of a *sulh* (compromise) scheme.

Another concern that may be raised over public borrowing is the negotiability<sup>88</sup> of public finance instruments, in other words, the liquidity concern. From the viewpoint of *Sharia*, the underlying asset of the instrument (security or *sukuk*) and the consent of the obligor/debtor are the two main concerns in the negotiability of an

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<sup>87</sup> *Asalat al-sehhat*

<sup>88</sup> For another definition of negotiability see John Murno 'The Medieval Origins of the Financial Revolution: Usury, Rentes, Negotiability' (The International History Review, vol. XXV, No. 3, 2003) pp. 546-555.

instrument. Regarding the former, it cannot be a fixed amount of cash, debt receivable, or credit (i.e., a fixed return or receivable instrument), but it has to be a non-monetary asset or contingent profit originating from real (non-monetary) assets. As to the latter, the default rule is that the consent of the obligor/debtor is required but it may be agreed otherwise by the parties to the contract. The nearest *Sharia* concept for this purpose is *hiwala*. This is a contract whereby a creditor may transfer his claim (debt receivable) against the debtor, who accepts to pay a third party designated by the creditor. To be a valid *hiwala*, this acceptance is required. *Hiwala*, in and of itself, cannot be used for trade and profit-making purposes but it is an intermediary instrument used for debt-relief purposes. Therefore, if negotiability is essentially made for trade and profit purposes, *hiwala* would not be a useful facility for this purpose. After all, the key issue in determining the negotiability of public finance instruments, e.g., those used in *malikane* and *esham* systems, depends on whether the underlying asset in these instruments, i.e., the tax income stream, is considered a fixed receivable or a contingent profit originating from real (non-monetary) assets. In the former case, unlike the latter case, they will not be acceptable negotiable instruments. Regardless of the concern over whether the underlying asset in these instruments is a fixed receivable or a contingent revenue, if it is assumed that the essence of a transaction is “transfer of ownership”, according to the *Sunni* school of thought unlike the view of the *Shia* school who argue that the essence of a transaction is “promise”, these instruments would not be negotiable. This is due to the redeemability<sup>89</sup> option that is often stipulated (as in the *malikane* and *esham* systems) in favour of the issuer

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<sup>89</sup> Note the difference between redemption (forced sale to the issuer at the price set in the certificate/security) and repurchase. For example as per NY laws, redemptions are set in the certificate, and must be done proportionally within each class of stock. In contrast, as to the repurchase, the general rule is that repurchases are individually negotiated, and the issuer can discriminate among the shareholders/security-holders (with one exception: in a closely held corporation, the corporation must give equal opportunity to all shareholders to sell back their stock to the corporation).



of instruments (i.e., the Treasury of State or the House of Wealth). According to the “transfer of ownership” theory, assuming that the legal essence of the negotiation of an instrument is a *bay* (sale), in order for an owner to sell his assets or property right, he has to own it first in an absolute manner. In other words, for exchangeability or negotiability of receivable instruments of public finance by their private holders (such as annuities in *malikane* and *esham* arrangements) these should not be subject to a revocability or redeemability option of the issuer (i.e., the Treasury of State or the House of Wealth). If the “promise” theory applies instead of the theory of “transfer of ownership”, the redeemability option will be less problematic and perhaps not problematic at all.

### 5.5.2 Personal Housing and Construction Projects

Housing is a very important basic necessity.<sup>90</sup> According to some scholars, in order to fund these types of projects the government can simply deposit a certain amount of money with a public financial institution, giving the specifications as to who qualifies and let the institution do the rest, i.e., lend the deposited funds to the qualified applicants. The government and the institution will not ask for any interest on the loans to the qualified people but the institution, by ensuring an appropriate loan repayment plan, has to take care that the original capital remains intact and is used continuously to give fresh loans.<sup>91</sup> *Qard hasana* (interest-free loan), *ijara* including *ijara-wa-iqtina* (leasing with a purchase option), *a’riya* (permission to use a house or construction equipment and tools free of charge temporarily), and *haq intifa* (enjoyment privilege) can be very proper methods in funding the acquisition,

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<sup>90</sup> See the Constitution of Iran article 43 (section 1).

<sup>91</sup> See A. L. M. Abdul Gafoor ‘Interest, Usury, Riba and the Operational Costs of a Bank’ (A.S. Noordeen, 2005) pp. 45-46.

construction, or use of housing. In respect of personal (non-commercial) housing or construction concerns, in case the borrower (in the acquisition of the ownership of a dwelling house) or lessee (in the acquisition of the usufructs of a dwelling house) defaults in the repayment of the loan (*qard hasana*) or payment of rental fees (*maal al-ijara*), the unpaid amount can be recovered from sources like *sadaqat* (almsgiving funds), *mawhubat* (gifted funds), *zakat* (wealth taxes) and *kharaj* (natural resource use premiums). Notably, the *qard hasana* facility is suitable only for individual housing and construction needs, but not for commercial use purposes.

### 5.5.3 The Education, Healthcare, and Academic (Scientific) Research

In terms of education, healthcare, and academic (scientific) research,<sup>92</sup> a one-off donation (*hiba*) can be a suitable option to help needy students to finance their education costs. The other way to fund education is to grant loans to needy students (interest-free long-term lending on the basis of *qard hasana*), and require them to repay exactly the granted amount of loan (*qard*) at the earliest convenient time. Another proposal may be to ask the students to repay the lent amount with some additional amount of money to cover the usual and necessary costs of borrowing, such as administration costs and the reduced value of the currency as a consequence of inflation (i.e., *qard* plus administrative costs plus depreciated value of cash).<sup>93</sup> As per the last option, it may be said that since the original fund remains intact, this would be a sustainable continuing operation with no need to provide fresh funds to keep the operation running. However, since access to education and also healthcare facilities are an essential public need and are also necessary for public welfare, the costs and

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<sup>92</sup> See the Constitution of Iran article 43 (section 1).

<sup>93</sup> See A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A.S. Noordeen, 2005) pp. 43-45.

expenses have to be paid from the source of public funds, specifically: public *mawqufat*, public *mawhubat*, *zakat* and possibly *kharaj*. An important means of supporting research and development projects<sup>94</sup> in academic and professional institutions is through the endowment of public or private properties in the form of *waqf* to specific research and development projects. These *waqfs* are called R&D *waqfs* and are managed by academic or professional institutions (as *mutawallis*/trustees of the *waqf*), who will pool together and pay a qualified group of researchers from the source of the *waqf* in return for carrying out certain research and development projects specified in the deed of the *waqf*.

#### 5.5.4 Micro-Business Activities

A suitable method for providing micro-business<sup>95</sup> financing is through cooperative financing. Individuals with common capabilities can establish a cooperative in order to run micro-entrepreneurship projects for their own interests.<sup>96</sup> The contribution of the cooperative members and also a long-term *qard hasana* (interest-free loan) provided by the House of Wealth are the two main sources for funding the cooperative. The cooperative is obliged to return the *qard hasana* (only

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<sup>94</sup> These not-for-profit R&D projects are those that are carried out for public welfare purposes.

<sup>95</sup> See the Constitution of Iran article 43 (section 2).

<sup>96</sup> Some micro-business enterprises can be initiated with the governments (the House of Wealth) or highly respected private sector institutions (who will act as trustee or manager of these microenterprises) by way of pooling public funds or the funds coming from not-for-profit or benevolent sources dedicated to micro-businesses as beneficiaries. Very similar schemes to these enterprises in the US are government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac (albeit, only in housing construction and business industry). There are some projects which are unattractive enterprises for investors but have to be implemented because they are socially the most necessary ones especially at the grass roots and micro levels. These are projects that actually bring direct benefit to the poor in small towns and villages, and those living in the slums of large cities. These kinds of projects have to be financed by the government (the House of Wealth)-sponsored enterprises. For a similar approach see A. L. M. Abdul Gafoor 'Islamic Banking & Finance: Another Approach' (A. S. Noordeen, Kuala Lumpur, Malaysia, 2000) p. 18.

the principal amount without any interest) to the House of Wealth within an agreed time. Public-private *musharaka* (especially public-private *mudaraba* and public-private *inan*) can be another way to finance micro-business. On the basis of public-private *musharaka*, the House of Wealth provides a given cooperative with a sufficient amount of assets in order to run specific projects. The profits derived from these projects will be shared between the House of Wealth and the cooperative's members as per their contributions (or through a mutually pre-agreed equitable ratio). On the basis of public-private *musharaka*, the House of Wealth may provide a given cooperative with non-monetary contributions, such as: equipment, raw materials, land, water, and machinery using *muzara'a* (crop-sharing), *musaqat* (produce-sharing), or similar<sup>97</sup> arrangements. The produce generated as a result of *muzara'a* or *musaqat* will be shared between the House of Wealth and the cooperative as per their contributions (or mutually pre-agreed equitable ratio). *Istisna* can also be used for microfinance purposes if a given cooperative is interested and has specialised in the field of manufacturing and construction projects. The House of Wealth, the state and any member of the public may order a given cooperative to construct or produce certain buildings, machinery, or any other products as per the specific specifications. The cost/price of the building, machinery, or any other ordered product is paid at the time of the order (*salam* contract). *Bay nasiya* (deferred payment sale) and also *ijara-wa-iqtina* (leasing with a purchase option) may also be used for ownership empowerment purposes i.e., selling specific goods and commodities in installments or at the end of a lease contract respectively.

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<sup>97</sup> For example, the state (the House of Wealth) may provide a given cooperative with necessary raw materials to produce carpets or some specific machinery. I will call this arrangement *musana'a* i.e., product-sharing (derived from *istisna*).

A tool that has been successfully used to combat poverty and also for microfinance purposes is the Grameen La Riba model<sup>98</sup> also called a “group lending methodology”.<sup>99</sup> This model is based on a “human portfolio approach”, which is in fact a variant of the financial portfolio theory.<sup>100</sup> This model is considered to be very effective because it significantly reduces default rates in repayment of loans, and also leads to lower-interest-rate loans.<sup>101</sup> In a group lending method, a microfinance institution (MFI) will provide funds to self-selected groups of borrowers together where no physical collateral to guarantee the loan (i.e., a *rahn*) is needed. However every single member will have to share collective risks and responsibilities with all the other group members (“social collateral”).<sup>102</sup> Besides the group lending model, some scholars<sup>103</sup> have found that “dynamic incentives” (e.g., further lending eligibility provided upon the punctual repayment of an existing loan), recurrent repayment schedule, and communal repayment plan can significantly lead to a lower rate of repayment defaults.

Other interesting proposals in respect of micro-business finance are using *murabaha* and *musharaka* schemes. As per the former scheme which is applied prior to the application of the latter one, a group of borrowers who approach a given MFI

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<sup>98</sup> This model was created by the Grameen Bank in Bangladesh founded by Muhammad Yunus, who was awarded (jointly with the Grameen Bank) the Nobel Peace Prize 2006, for its efforts to create economic and social development.

<sup>99</sup> For more detail see Ehsan Habib Feroz and Blake Goud ‘Grameen La Riba Model: A Strategy for Global Poverty Alleviation’ (Journal of Islamic Economics, Banking and Finance. vol. 5, no. 2) pp. 83-85.

<sup>100</sup> In other words, a group of risky borrowers is pooled instead of pooling risky debt securities (*sukuk*) as it is practised in modern finance.

<sup>101</sup> See Ehsan Habib Feroz ‘The Halal Way to Social Change: Is There a Way to Pursue Grameen's Social Agenda without Using Interest?’ (Islamic Horizons, January/February 2007) p. 42.

<sup>102</sup> It may be said that people in society have a kind of joint and several responsibility towards each other. The destiny of people in society is dependent on one another. For a similar idea see Murtaza Mutahhari ‘Barrasi-ye Ijmali-ye Mabani-ye Iqtisad-e Islami’ (Tehran, Hikmat publications, 1<sup>st</sup> edition, 1403 Lunar Hijri Calendar) pp. 175-177.

<sup>103</sup> See Beatriz Armendáriz and Jonathan Morduch ‘The economics of Microfinance’ (Cambridge: MIT Press, 2005).

for financing will be offered for sale items needed to run a given micro-business on the basis of a *murabaha* facility (cost-plus resale with deferred payment). Having successfully completed a business cycle on the basis of a *murabaha*, then the MFI will determine whether to offer further financing to the borrowers on the basis of a *musharaka* facility, in which the MFI and the group members will have to share profits and losses of the micro-business as per a mutually pre-agreed ratio.<sup>104</sup>

## **5.6 Best Western Not-For-Profit (Profit Free and Philanthropic) and Microfinance Practices**

There are some best modern practices for financing in the not-for-profit and microfinance context that are good enough to be adopted into the new alternative model with only some improvements to their structure and characteristics. These are not only successful and popular, but are also consistent with the fundamental principles of the model and *Sharia* rules and objectives. These best practices are: cooperatives, pension funds, and (charitable) trusts.

### **5.6.1 Cooperative**

A cooperative is a kind of commercial enterprise or association jointly owned and operated for a common purpose or for the joint economic benefit of its members. It is usually set up by consumers or producers, particularly farmers, who produce and distribute goods and services. In general, individuals whose professions are similar may set up a cooperative together. The philosophy of the cooperative is to provide mutual

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<sup>104</sup> See Ehsan Habib Feroz and Blake Goud 'Grameen La Riba Model: A Strategy for Global Poverty Alleviation' (Journal of Islamic Economics, Banking and Finance, vol. 5, no. 2) pp. 85-97.

assistance and serve a useful function for the benefit of members of the cooperative. A good example of a cooperative is an apartment cooperative, where a corporation is established to build and operate apartment blocks.<sup>105</sup> The shares of the corporation are owned by the occupiers of the apartments pro rata to the value of the particular apartment occupied by each of them. The contribution of the participants to a given cooperative can be made either in the form of cash or in kind, especially their expertise and professional services with regard to production and distribution of goods and the provision of certain services.

The huge potential of cooperatives for social and economic development has already been extensively researched.<sup>106</sup> It proves that a law (which is considered to be a powerful “social engineering” tool) conducive to the improvement and growth of cooperatives could have a very strong positive impact on socio-economic development. However, since cooperatives are essentially different from ordinary business schemes because they are socio-economic self-help associations which are “member-oriented”, that is to say member participation is of significant importance and control is not according to the amount of the each member’s contribution, a new type of law for cooperatives is required. As per Shah, cooperative law must be a law of people i.e., it must be written by and for the people who are most directly engaged in cooperatives at the grass roots.<sup>107</sup>

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<sup>105</sup> The largest cooperative effort in the US known as “Co-op City” was developed by the United Housing Foundation (UHF) in New York which now accommodates over 15,000 families, or about 40,000 people. The Co-op City has three shopping centres with co-op supermarkets, its own nursery schools, credit unions, and also a multitude of civic and social organizations, which has made it an integrated and well-rounded community. For more information in this regard see <http://www.ilr.cornell.edu/library/kheel>.

<sup>106</sup> For example see Alfred Hanel ‘Basic Aspects of Co-operative Organizations and Co-operative Self Help Promotion in Developing Countries (Marburg, Marburg Consult for Self-Help Promotion, 1992).

<sup>107</sup> See Ashish Shah ‘Cooperative Law: An Instrument for Development’ (International Labour Review, Vol. 131, Issues 4-5, 1992, pp. 513-524) pp. 513 and 523.

There is no concern over *Sharia*-compliance for cooperatives. In fact, the idea of a cooperative is well represented in *Sharia*. The most referred to one is the concept of *ta'awun* (mutual assistance).<sup>108</sup> Cooperatives are widely used in Islamic countries such as Iran.<sup>109</sup> Since the cooperatives are essentially not-for-profit organisations, the liability of the participants does not usually go beyond the total assets of the cooperative. Some scholars may argue for a limited liability standard in cooperatives (and also in any other not-for-profit organisations and philanthropic foundations) according to the concept of *ihsan*<sup>110</sup> (acting for the benefit of others) in *Sharia*.

### 5.6.2 Pension Fund

A pension fund is a financial vehicle that regularly collects contributions from specific sponsors reserved to pay specific workers' pensions when they retire. They are set up by private corporations and also governments to pool certain assets in an independent legal entity (usually a trust) in order to finance the benefits and obligations of a pension plan. In modern economies, especially in the US,<sup>111</sup> pension funds have become very important institutional investors simply because they have made it possible for many members of the public to become participants of capital markets. For example, factory floor workers have become participants of capital

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<sup>108</sup> As per the Quran (5:2) "help one another in acts of righteousness".

<sup>109</sup> Cooperatives are strongly encouraged and widely used in Iran. They are governed under the Constitution of Iran articles 43 (section 2) and article 44; Iran Commerce Code articles 190-194; Cooperatives Act (with subsequent amendments) 1971 and Act on Cooperative Sector of Economy of Islamic Republic of Iran 1991 (especially article 1 sections 1-2).

<sup>110</sup> As per the Quran (55:60) "can the reward of goodness be any other than goodness?" Also as per the Quran (16:90) "surely Allah enjoins justice, kindness and the doing of good?".

<sup>111</sup> In the US, pension funds are regulated by the Department of Labor under an Act of Congress called ERISA (Employment Retirement Income Security Act) enacted in 1974 primarily to protect against inadequate funding, to establish benefits and also to impose fiduciary duties on the part of those (trustees) who manage the pension funds.



markets through their relevant pension funds. In the past, in particular in the US, pension funds were only funded and guaranteed by employers. Now however, private industries, but not governments,<sup>112</sup> have converted their pension funds from the original “defined guaranteed pension” model (also referred to as “defined benefit plan”) to a “defined contribution plan” model, in which the employer only guarantees that it will contribute when employees also contribute. The contributions that are

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<sup>112</sup> The Bush administration tried to convert social security to a contribution plan instead of a defined guaranteed plan. Republicans are still trying to get this done.

made to the pension fund are usually invested in the stock markets and the generated proceeds are distributed to the pension fund beneficiaries.<sup>113</sup>

Considering the implications of the research theory as well as the suggested alternative model, there would be no employment structure, as it is understood today, in the profit-making industry section although it would still be in operation in the not-for-profit and public-function spheres. Therefore, only governments, public entities, and not-for-profit organisations may set up pension funds. Other challenging issues surrounding pension funds are the legal nature of pension funds and also the disposal

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<sup>113</sup> For more on the most common types of pension funds and the difference between “defined contribution” plan and “defined benefit” plan see Gregory L. Prescott and Jeanne Sylvestre ‘Pension Underfunding: How Big is the Problem’ (Commercial Lending Review, Vol. 18, Issue 3, May 2003, pp. 22-31) pp. 22-23. As per Prescott and Sylvestre, pension schemes are basically set up by many employers in order to attract and retain highly-qualified employees, who do want to reach their retirement savings aims. Under “defined contribution” schemes, the employer promises to contribute to a pension fund a certain amount each period based on a specific formula. What the employer promises is in fact to contribute a certain defined sum; no guarantee is made regarding the ultimate benefits have to be made to the employees. But, under “defined benefit” plans, the employer specifically guarantees the benefits (typically, on the basis of an employee’s years of service and also the employee’s compensation level at the time of retirement) paid out to the employees at the time of their retirement. In the UK, there are two main routes a person can start saving for a pension- obtaining one through her job or joining a personal pension plan. It is possible to use both types of pension plan simultaneously if a person wants to do so. In practice, there are many different kinds of pension plans but the most common types are: occupational pensions (also referred to as company pensions), personal pensions, and stakeholder pensions. Each pension scheme is made up of individual pension pots for each member- also known as pension arrangements. The two most common types of arrangements are: money purchase (also known as “defined contributions”) and “defined benefits”. Under the “defined contributions”, the person builds up a pension pot that will provide her with her pension. The value of the pension pot she will receive when she retires depends on how much money she contributes and how well the funds are invested i.e., how much pension her pension pot can “buy”. Under the “defined benefits”, the amount of pension she will receive when she retires does not depend on the size of her pension pot. She will be guaranteed a certain amount of pension at her retirement. The amount of her pension normally depends on her pay and length of service in her job. See UK Government HM Revenue & Customs website at <http://www.hmrc.gov.uk/pensionschemes/understanding.htm>. Retrieved 4 April, 2013.

of the assets of the pension fund. From an Islamic viewpoint, it may be argued that a pension fund is established on the basis of *waqf* rules. In this case, as per *Sharia*, the contributions cannot be made in cash and not by the beneficiaries themselves but must be made by persons other than the beneficiaries of the *waqf*. In respect of the disposal of the assets of the fund, they cannot be disposed of for investment purposes if the legal nature of the fund is deemed to be a *waqf*. Some may argue that a pension fund can be set up based on the concept of *ta'awun* (mutual assistance) in the *Sharia*. In this case, contributions to the fund should basically be made by the beneficiaries themselves and the contributions can be both in cash and in kind. Others may argue that the establishment of the pension fund can be made through the concept of *sulh* (compromise). This also makes sense from the viewpoint of *Shia* scholars but not to scholars of the *Sunni* school.

### 5.6.3 Trust

A trust is a legal facility that allows an owner of property called a settlor (the person who creates the trust, also called creator) makes a delivery<sup>114</sup> of a legal title to the property<sup>115</sup> (also called the corpus, *res*, or principal) to a trustee<sup>116</sup> who holds<sup>117</sup>

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<sup>114</sup> In a trust, titled assets e.g., deeds and stock certificates must be formally transferred to the trustee for delivery to be valid.

<sup>115</sup> The property can be almost anything, but must be property that the settlor owns, not just a mere expectation of ownership in the future. The property must be specific and identifiable, not subject to future determination. In a trust that the corpus property of the trust is a bank account, it is called Totten Trust (or Bank Account Trust). The Totten Trust is a bank account in the depositor's name "as trustee for" a named beneficiary. The depositor (the creator of the trust) can make deposits and also withdrawals as he wishes during the depositor's lifetime. The beneficiary has no beneficial interest during the depositor's lifetime, but gets whatever is in the account when the depositor dies.

<sup>116</sup> The trustee can be the settlor himself.

the legal title for the benefit of a beneficiary<sup>118</sup> with the intention of creating a trust for a lawful purpose in a validly executed<sup>119</sup> document.<sup>120</sup> An important point that should be noted is that in trust setting, the settlor or the person who manages the trust (i.e., trustee who takes control of the trust property under custody but not possession) has legal title to manage the trust but the equitable title belongs to the beneficiaries who receive the distributions from the trust.

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<sup>117</sup> The trustee can sell, mortgage, or lease any real or personal property, but he cannot engage in self-dealing, borrow money on behalf of the trust, or run/continue a business (the trustee is liable for losses incurred by the business unless a trustee has court approval to run/continue the business). However, with regard to the trustee's investment power, the trustee must manage the property of the trust on behalf of the beneficiary, and this means the investment of the corpus of the trust. For example New York State in the US has adopted the Uniform Prudent Investor Act "UPIA" that gives broad latitude to trustees to choose investments. Trustee can pursue what UPIA calls the modern portfolio theory of investment, where the trustee creates a tailored investment strategy for this particular trust.

<sup>118</sup> At least one beneficiary who is not the settlor is required. The settlor cannot be the sole beneficiary when also named the sole trustee (the merger of legal and equitable title in one person i.e., the settlor). But, the settlor can be the sole beneficiary when the trustee is somebody else other than the settlor himself. Furthermore, the settlor can be an income beneficiary for life. The settlor's estate can be one of the beneficiaries of the principal so long as there is at least one other beneficiary.

<sup>119</sup> The settlor can retain the power to revoke (terminate) or amend the trust. All trusts are presumed to be irrevocable, unless the trust explicitly authorises revocation. As to modifications, trust modification is appropriate only when the purpose and objectives of the trust would be defeated or substantially impaired if the trust were not modified.

<sup>120</sup> For more on trusts in the US see New York EPTL (Estates, Powers, and Trusts Law), which governs substantive law relating to trusts and wills. Also for more on Trusts, especially in England see J E Penner 'The Law of Trusts' (Oxford University Press, 6<sup>th</sup> edition, 2008) pp. 14-18, 50-86, 230-300, and 440-466. According to Halsbury's Laws of England, there is no universally understood definition of a trust but only a number of key features of a trust are often provided for this purpose. See Halsbury's Laws of England (Vol. 48, 2007 Reissue) Trusts. As per many legal scholars and comparative jurists, trust is characterised as an English, or widely common law, concept and is traditionally excluded from civil law systems. For example see F. W. Maitland in 'Selected Essays' edited by H. D. Hazeltine, G. T. Lapsley and P. H. Winfield eds. (Cambridge University Press, 1936) p 129. According to Maitland, trust is England's largest export to the world of legal theory. As per some scholars, the ostensible distaste civil law systems have for the common law trust can be traced back to each system's respective approach to rights in property and at least some degree of mistranslation. This apparent gap in understanding can be bridged by examining the trust in the more ancient Roman law concept of the "patrimony", thereby making the trust more acceptable to civil law jurisdictions. In filling the gap, however, this new appreciation for the trust can be challenging for common lawyers since they will have to reconsider "the traditional common law premise of the trust as being less about proprietary interest as it is about personal rights and obligations". See James Sheedy 'Civil Law Jurisdiction and the English Trust Idea: Lost in Translation' (Denning Law Journal, Vol. 20, pp. 173-184) p. 173.

The closest concept to a trust<sup>121</sup> in *Sharia* is a *waqf*<sup>122</sup> (endowment) and a *wasiyyat tamliki*<sup>123</sup> (possessory will). A *waqf* is similar to a lifetime (*inter vivos*) trust and a *wasiyyat tamliki* is similar to a testamentary trust. The main differences between trust law and *waqf* are that: a) in a *waqf*, unlike a trust, only such property that can be exploited without having a detrimental effect to its existence can be endowed; b) in a private *waqf* though not generally in a public<sup>124</sup> *waqf*, unlike a trust, a *waqif* cannot be included as a beneficiary; c) a *waqf*, unlike a trust, after being duly executed, is not revocable by the creator; and d) a *mutawalli* in a *waqf*, unlike a trustee in a trust, cannot dispose of the *waqf* assets except in very rare circumstances. However, in contrast, in a *wasiyyat tamliki*, the asset that is transferred under the will can be any type of asset whether it is monetary or non-monetary, and it can even be a mere expectation of ownership. It is revocable until the *musy* (testator) dies, and it becomes complete when the beneficiary, if they are identified, but not if it is made for public purposes, accepts the will. In a *wasiyyat tamliki*, a *musy* cannot bestow more than one

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<sup>121</sup> It should be noted that from a wide perspective, there are two types of trusts: lifetime (or *inter vivos*) trust and testamentary trust.

<sup>122</sup> For more on *waqf* see Iran Civil Code articles 55-91. For more analysis see Nasser Katouzian “Huquq Madani: Uqud Mu’ayyan’ (Tehran: Ganje Danesh Publications, vol. 3, 6<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 115-272.

<sup>123</sup> In *Sharia*, will is divided into two categories: possessory (*tamliki*) and promissory (*ahdi*). A possessory will occurs when a *musy* (testator) bestows on another person (called *musa lah* i.e., beneficiary), without charge, the property (called *musa bih*) in a thing or a benefit belonging to him to take effect from the date of his death. A promissory/contractual will occurs when a person (called a *musy* i.e., testator) appoints one or more other persons (called *wasy*) to carry out an affair, or to perform other legal acts after the *musy* dies. For more on *wasiyyat tamliki* see Iran Civil Code articles 825-853. For an analysis see Nasser Katouzian “Huquq Madani: Uqud Mu’ayyan’ (Tehran: Ganje Danesh Publications, vol. 3, 6<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 273-447.

<sup>124</sup> Public *waqf* in *Sharia* is similar to a charitable trust in common law. A trust where the beneficiaries are a reasonably large enough group to consider the number of beneficiaries indefinite is called a charitable trust. In other words, a charitable trust cannot have specific, named persons as beneficiaries. Charitable trusts must be for a charitable purpose such as health, education, and religion and they may be perpetual (i.e., last forever). In case the stated purpose of the charitable trust can no longer be pursued, or the designated charity ceases to exist, the court may order that the trust be as near as possible to what the settlor intended. The beneficiaries of the charitable trust are represented by the attorney general, who represents the public.

third of his total outstanding assets, unless the testator's estate ratifies the excess. It can be concluded that modern trusts can be considered as best practice<sup>125</sup> but require some adjustments to be implemented under the new suggested model. Among all types of trust in modern legal systems, charitable trusts are the closest type of trust to the *Sharia* (public) *waqf*.

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<sup>125</sup> It is believed that the endowment deed of Merton Foundation which established Merton College of Oxford University in 1264 and later became a successful model in England as well as the Peterhouse Foundation which established Cambridge University were very similar to an Islamic waqf. See Monica Gaudiosi 'The Influence of the Islamic Law of Waqf on the Development of the Trust in England: The Case of Merton College' (University of Pennsylvania Law Review, vol. 136, No. 4, 1998) pp. 1231-1261.

## **Chapter Six:**

# **Part Six of the Second Tier of the Model (6): Intermediary Facilities**

## **6.1 Introduction**

Today, intermediary services are widely used in many areas from politics to capital markets, to the banking sector. A well-functioning economic and financial system has to facilitate the circulation of surplus assets, the performance of exchange transactions and provide facilities to cater for the proper transfer of funds and the settlement of debts in the economy.

Intermediaries are the key players in any economy and this is easily recognisable by huge volumes of transactions carried out among anonymous participants that have limited knowledge and access to directly assess each other's products and services. That is why it can be said that that, in modern world, few consumers or investors do transaction without relying directly or indirectly on the facilities that the intermediaries provide e.g., information that they gather and evaluate.<sup>1</sup>

In this section, in order for necessarily proper functioning of the suggested new model, I propose to discuss some major and necessary intermediary tools and services as follows.

## **6.2 Tools and Services**

The following are the major tools and facilities that can be used for the purpose of intermediary activities.

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<sup>1</sup> See Jonathan M. Barnett 'Intermediaries Revisited: Is Efficient Certification Consistent with Profit Maximization' (Journal of Corporation Law, Vol. 37, Issue 3, Spring 2012) pp. 476-477.



### 6.2.1 Agency (*Wakala*)

*Wakala* (agency)<sup>2</sup> is a contract whereby a person (*muwakkil*) appoints an agent (*wakil*) as his representative to accomplish some legal or administrative matters on his behalf free of charge or in return for some fees. *Wakala* may be general and cover all legal and administrative affairs of the *muwakkil* or may only be for some specific legal and administrative concerns. A *wakil* has a duty to act in the best interests of a *muwakkil*. He cannot receive a benefit to the detriment and at the expense of the *muwakkil* (principal). If the *muwakkil* suffers losses due to the misconduct or negligence of the *wakil*, he will be liable to make good the losses suffered by the *muwakkil*. *Wakala* for specific legal and administrative affairs also implies *wakala* (agency) for necessary acts to accomplish those affairs, unless it is expressly excluded. A *muwakkil* is obliged to reimburse all costs and expenses incurred by the *wakil* for the accomplishment of *wakala* matters and also compensate the *wakil* as per the mutually-agreed terms. The due compensation of the *wakil* will usually be a fixed fee. However, there may also be a performance-based fee, but it will not be based on a profit-sharing arrangement.<sup>3</sup> A *wakala* is a permissive contract and a *muwakkil* (principal) may terminate it with a prior notice to the *wakil* unless it is made obligatory as per the mutually-agreed terms in a legally binding contract. *Wakala* may be used for intermediary purposes, such as for the negotiation and execution of legal documents or the transfer and settlement of debts.

Another intermediary service is *mua'mala bi al-nafs* i.e., self-dealing agency. According to the Islamic *Sunni* school of thought, if a person is appointed as an agent to do a transaction, his capacity as an agent has to be distinguished from his capacity

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<sup>2</sup> Agency is the closest modern concept to *wakala*. See Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 431-444, articles 656-683.

<sup>3</sup> The reason is that *wakala* is not used for profit-making business and investment purposes.

as a party to the transaction. For example, after buying shares on behalf of the principal and before selling the shares to himself, the agent must inform the principal that he has bought the shares and then in order for the shares to be sold to the agent himself (i.e., as a prospective buyer), a separate proper offer and acceptance has to have occurred between the principal and the agent. However, it seems there is no need for such separate offer and acceptance steps, at least from the viewpoint of the *Shia* school of thought. As per the view of *Shia*, in a transaction, one person may represent both parties to the transaction and he may also transact with himself as a party to a transaction while acting as an agent of the other party to the transaction. However, in these circumstances, the terms of the self-dealing contract should be reasonable and in strict conformity to the dominant conditions of the market.<sup>4</sup> This difference becomes very important especially in the function of modern financial intermediaries in exchange markets and also clearing and settlement houses e.g., modern Central Counter Parties (CCPs). On the basis of this concept, CCPs are able to act as agents of both parties to a transaction without getting involved in two separate contracts with each party to settle the debt obligations.

### 6.2.2 Safe-Keeping Deposit (*Wadi'a*)

*Wadi'a* or *Amana*<sup>5</sup> is a contract whereby one party called a *mude'* (depositor) entrusts a property belonging to him to another party called a *mustawde'* or an *amin* (deposit-taker) in order that the latter retains and holds it for him free of charge or in return for some fee. The deposit taker is not liable for any loss or damage to the entrusted property unless it occurs as a result of his default. Islamic scholars are

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<sup>4</sup> See Iran Civil Code articles 198 and 1072. See also Iran Commerce Code articles 358, 373, 374.

<sup>5</sup> See Iran Civil Code articles 607-634.

divided on whether the parties in a wadi'a/amana contract may stipulate a condition whereby a deposit-taker would have to guarantee the return of the deposit to the depositor. Some believe that such a guarantee is in contradiction to the inherent characteristics of a wadi'a /amana contract but others argue for its validity. Considering the salient characteristics of wadi'a/amana, it seems that the former view is solid.<sup>6</sup> The ownership of the deposit remains with the depositor, and that is why all the risks and benefits associated with the ownership of the deposit will be borne and utilised by the depositor. A deposit-taker is responsible for returning the exact same deposit entrusted to him upon the request of the depositor. The deposit-taker is not permitted to use the entrusted property for his own benefit unless permission is granted by the depositor. However, this use may be for very limited purposes, otherwise the rules of an *a'riya* (use-free permission) contract will apply. All costs and expenses required for maintenance of the entrusted property will be paid or reimbursed by the depositor. This facility may be used for depositary purposes in capital markets and also financial institutions, especially banks.

### 6.2.3 Assignment of Debt Obligations/Receivables (*Hiwala*)

*Hiwala* is a contract whereby a debtor called a *muhil* (assignor) transfers his debt obligation to a third party called a *muhalun alayh* (delegee), who agrees to pay the creditor, called a *muhtal* (assignee) designated by the *muhil* (assignor).<sup>7</sup> Similarly, if the creditor called a *muhtal* (assignor) transfers his debt receivable against the debtor called a *muhalun alayh* (delegee), who assumes to pay a third party beneficiary called a

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<sup>6</sup> For more about different ideas in this regard see Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> Edition, 1387 Solar Hijri Calendar) p. 417, article 614.

<sup>7</sup> For more see Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> Edition, 1387 Solar Hijri Calendar) pp. 459-463, articles 724-733.

*muhtal* (assignee). For the validity of the *hiwala*, which is initiated by the debtor or creditor (*muhil*/assignor), the consent of the *muhtal* (assignee) and also the acceptance of the *muhalun alayh* (delegee) are required. Furthermore, for the validity of *hiwala*, a solid legal or contractual cause of the debt receivable/obligation is necessary, though it might not be still realised and it is contingent. If the assignor (*muhil*) is not indebted to the assignee (*muhtal*), *hiwala* rules will not be applicable. In this case, the reason for assignment of a debt receivable/obligation may be a *hiba* (gift) or a *qard* (loan) or merely the appointment of the assignee by the assignor to collect his debt claims. However, for the validity of *hiwala*, it is not necessary that a delegee (*muhalun alayh*) be indebted to the assignor (*muhil*). In this case, the delegee (*muhalun alayh*) will be treated as a guarantor (*damin*). After all, when *hiwala* is validly concluded, *muhil* (assignor) is discharged of the incumbent debt obligation towards the assignee, and the payment obligation attaches to the delegee (*mulahun alayh*). This is the default rule as per the Shia school of thought. In contrast, the relevant default rule in the Sunni school of thought is that a *muhil* (assignor) is not discharged of the debt obligation, but his obligation attaches to the obligation of the delegee (*mulahun alayh*) which is created as a result of *hiwala*. That is why, from the viewpoint of the Shia school of thought, the closest concept to *hiwala* in modern terminology is novation. If, in a sale or any other contract, the seller/creditor executes a *hiwala* (assignment) arrangement providing that the buyer/debtor has to pay the price (i.e., satisfy the debt obligation) to some other person (*muhtal*); or, similarly, if the buyer/debtor executes a *hiwala* (assignment) arrangement authorising the seller/creditor to receive the price (i.e., collect the debt receivable) from someone else (*muhalun alayh*), and the nullity of the sale or the other underlying contract is established, *hiwala* would be null. If the *muhtal* (assignee) has received the price he must give it back; but if the sale or the other underlying contract gets revoked as a result of the exercise of a contract termination option by one party (called *faskh*) or by

mutual consent of the parties to the contract (called *iqala* or *tafasukh*), the *hiwala* would not be null, but the *muhalun alayh* (delegee) is discharged, and the seller/creditor or the buyer/debtor may have recourse against one another. As per Islamic law, in contrast to civil law, in the assignment/transfer of debt or claim (*hiwala*), all guarantees, collaterals and securities attached to the debt or claim are automatically wiped out.<sup>8</sup> A *hiwala* facility may be used for payment, transfer of funds, and the settlement of monetary debt obligations and receivables.

#### 6.2.4 Bond-Like Securities (*Sukuk*<sup>9</sup>)

*Sak* (singular of *sukuk*) is a document or certificate, which represents the undivided *pro rata* ownership of an underlying contract or asset, which may be a building or any other asset or project. In other words, *sukuk* are financial instruments which evidence a beneficial entitlement to an underlying asset, and can be structured in and achieved through the use of assets and various contractual techniques to conform to *Sharia* principles.<sup>10</sup> According to Moody's<sup>11</sup>, *sukuk* are defined as "trust certificates or participation certificates that grant the investor a share of the asset along with the cash flows and risk commensurate with such an ownership". According to IOSCO's report,<sup>12</sup> *sukuk* is a generic term used to cover a wide range of financial

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<sup>8</sup> See Muhammad Jafar Jafari Langroodi 'Huquq Madani: Aqd Daman' (vol. 4) Numbers. 49-56.

<sup>9</sup> As per Zeti Akhtar Aziz, 11.7 percent of the total global Sharia compliant assets are constituted by *sukuk* (see Zeti Akhtar Aziz 'Enhancing the Resilience and Stability of the Islamic Financial System' (Kuala Lumpur: Islamic Financial Services Board and Institute of International Finance Conference, 20 Nov. 2008)).

<sup>10</sup> See IOSCO 'Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products' (2008) pp. 7-8 and 13.

<sup>11</sup> See Moody's 'Special Report on Sukuk' (25 February, 2008).

<sup>12</sup> See IOSCO 'Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products' (2008) pp. 8, 13.

products designed to match different purposes.<sup>13</sup> There is, thus, an array of different *sukuk*. As per AAOIFI, there are fourteen different underlying Sharia contracts (or their combinations) on the basis of which the *sukuk* certificates may be structured. In practice, however, often *musharaka*, *mudaraba*, *murabaha*, *salam* (forward sale), *istisna* (construction finance), *ijara* (leasing)<sup>14</sup> and *manfa'a* (the sale of the usufruct of assets and properties) are used. As per IOSCO's report, from an economic perspective, there are three common types of *sukuk*: a) fixed-income *sukuk*, b) asset-backed *sukuk* (ABS), and c) hybrid *sukuk*. In the first type of *sukuk* which tends to be asset-based rather than asset-backed, the risk is related to the credit risk of the originator and in the second one, the risk is related to the "performance of the underlying asset". Where the credit risk of the originator and the underlying asset risk are combined, the *sukuk* will be a hybrid *sukuk*. The first type of *sukuk* may have underlying assets, but in essence "they require some form of guarantee or purchase undertaking from the issuer". This is similar to "a conventional debt security in terms of risk characteristics and performance". The second types of *sukuk* are "instruments which are more akin to conventional asset-backed securities". Hybrid *sukuk* which have also emerged, comprise both the risk of "performance of the underlying asset and the credit risk of the issuer".<sup>15</sup>

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<sup>13</sup> A *sukuk* instrument could potentially become a powerful financing tool for corporations and governments as well as a refinancing tool for housing and commercial Sharia-compliant mortgages. See Rodney Wilson 'Islamic Finance in Europe' (European University Institute, December 2007) p. 4.

<sup>14</sup> As per the Deutsche Bank Global Markets Research, due to decrees from *Sharia* experts on 'the permissibility of certain contractual stipulations within some structures', it is possible that the practice of the *ijara* instrument will become more persuasive. See Deutsche Bank 'Global Markets Research' (August, 2007).

<sup>15</sup> See IOSCO 'Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products' (2008) p. 13.

Modern *sukuk* are better described as Islamic investment or financing certificates. According to Wilson,<sup>16</sup> *sukuk* should not simply be deemed a substitute for secular interest-bearing securities. The intent is not simply to engineer financial instruments that replicate “fixed-rate bills and bonds and floating-rate notes” as practised in the West, but rather to introduce new types of assets that comply with *Sharia* rules. *Sukuk* bonds collect an income stream from underlying assets instead of bearing interest, which is banned in Islam. According to *Sharia* principles, securities including *sukuk* must be backed by real underlying assets, rather than being merely paper derivatives. Also, returns from securities must be connected to the purpose for which the funding is used, and not simply comprise of interest. The *Fiqh* Academy of the OIC has ruled<sup>17</sup> that any pool of assets can be embodied in a written<sup>18</sup> note or bond and such a bond or note can be exchanged at a market price provided that the pool of assets represented by the security, consists of a majority<sup>19</sup> of tangible assets and financial rights, with only a minority being “cash and interpersonal debts”.

According to the recommendation of AAOIFI, the return of the invested capital at maturity must not be guaranteed. However, in practice, in almost all of the *sukuk* issued, the return of the principal capital at maturity (i.e., the par value of the *sukuk*) is guaranteed in favour of the *sukuk* holders by way of an obligation of the *sukuk* issuer to repurchase the underlying assets represented by the *sukuk* at the original price that they were bought by the *sukuk* holders (this is called redemption). This is exactly what

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<sup>16</sup> See Rodney Wilson ‘Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk (Overview of the Sukuk Market)’ (University of Durham: Institute for Middle Eastern and Islamic Studies) p. 3.

<sup>17</sup> It was in its decision number 5 of 1988.

<sup>18</sup> *Sharia* encourages the documentation of contracts as stipulated in the Quran (2:282): “When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing ... It is more just in the sight of God, more suitable as evidence and more convenient to prevent doubts among yourselves.”

<sup>19</sup> However, as it has been discussed earlier it is not necessary that the pool of assets consists of a majority of tangible assets. A considerable amount is enough in this regard.

is practised in conventional bonds today (a conventionalisation problem in modern Islamic finance). However, even if it is not possible to stipulate in the *sukuk* certificates that the issuer of the *sukuk* is obliged to buy back the *sukuk* (i.e., to guarantee) for a nominal price (at par value), it seems it is completely possible to stipulate that the issuer will have an option (but not an obligation) to repurchase the *sukuk* at the prevailing market price or a mutually agreed price on the basis of *bay shart* or *bay wafa* (sale-with-repurchase-option) arrangement according to the *Shia* school of thought. Also, the revenue or profit to be generated from the underlying asset (principal capital) may not be guaranteed (it should be noted however that this is not a problem in the *sukuk* where the underlying contracts/assets are *salam*, *murabaha* or *ijara* or other similar *Sharia* contracts in which the price or rent is a fixed amount at the time of the contract). However, in practice, almost a fixed return of the principal benchmarked to the prevalent interest rate is guaranteed (again, another conventionalization concern in modern Islamic finance). Therefore, what is an essential characteristic of the *sukuk* is that the profit or revenue of the invested capital must be linked to the performance of the relevant underlying assets or projects and the principal capital of the investors (*sukuk* holders) may not be guaranteed.<sup>20</sup>

### 6.3 Applications of Alternative Intermediary Tools and Services

The following are the major alternatives for performing intermediary activities.

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<sup>20</sup> For some similar discussion in this regard see S. Mohamad, M. F. Yusoff and A. A. Al-Qassar 'Ground Rules for Sukuk Issuance (in Thomas A. (Ed.), *Sukuk*)' (Selangor: Sweet & Maxwell Asia) p. 42. Also see Muhammad Taqi Usmani 'Sukuk and Their Contemporary Applications' (5 October 2008) p.4. Available via the Internet at <http://www.muftitaqiusmani.com/ArticlePublication.aspx>



### 6.3.1 Payment and Deposit Intermediaries (PDIs)

Payment and deposit intermediaries (PDIs) need to be set up to facilitate the circulation of funds and the provision of some financial services. These are financial institutions to provide services such as safe-keeping of deposits of the capital holders, transferring funds, settling the debt obligations and also providing other services like the provision of contractual guarantees using an *aqd daman* facility.

Taking deposits by PDIs will be done on the basis of *wadi'a/amana*. These deposits can neither be utilised for the profit-making activities of PDI nor in its money creation purposes on the basis of a fractional reserves facility, which is now practised in the modern banking system. The title of deposits will remain with the depositors and they will have a right to control capital, including determining how it is used, who uses it, whether to lend or exchange or do another transaction on it, and the right to the revenue generated by the use of the capital. PDIs will act merely as a trustee (*amin*) or a *wakil* (agent) of the depositors and will keep the deposits safe free of charge or in return for a service fee and will return the funds to the depositors at the end of the *wadi'a/amana* contract or at the demand of the depositors.<sup>21</sup> PDIs will issue debit cards to the account-holders who have deposited their capital with them. The account-holders/consumers may then use the debit cards to pay retailers for their day-to-day shopping transactions. PDIs will not be permitted to use the deposits at their discretion, i.e., neither lend them out to others nor use them for investment

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<sup>21</sup> With regard to the legal nature of the bank account (or, the bank balance), Dalhuisen argues for a particular (*sui generis*) proprietary right in this regard and he calls for some necessary adjustments to the traditional view that considers a balance in a bank account merely a contractual right against a bank. See Jan H. Dalhuisen 'Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law' (Hart Publishing, vol. 3, 4<sup>th</sup> edition, 2010) p. 331.

purposes.<sup>22</sup> Investment and trade activities under the schemes, such as; *mudaraba*, *musharaka*, and *murabaha* require a totally different management structure with different expertise and skills than modern conventional banking management styles. In the former management style, the management team cannot detach itself from the underlying real investment or entrepreneurial activities that they finance, while in the latter style the management team does not want to engage in the underlying business activities. These two distinct approaches demand two different institutions. The second activity can be responded to through the establishment of PDIs, but the first activity should be responded to by different arrangements such as *mudaraba* partnerships, *musharaka* partnerships, and venture capitals.<sup>23</sup>

In addition to deposit taking and debit card services, PDIs may provide payment or transfer of fund services (e.g., bill of exchange or letter of credit services which are called *suftaja*<sup>24</sup> in Islamic finance). “Funds transfer” is a generic name that is used for non-cash payments carried out through the banking system following the instructions of a bank customer. As a result of “funds transfer”, a credit balance is being transferred from one bank account to another bank account, regardless of whether the two bank accounts are both in the same bank or two banks, and irrespective of

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<sup>22</sup> For a detail analysis on the legal nature of deposits before banks see Nasser Katouzian ‘Huquq Madani: Uqud Mu’ayyan’ (Tehran, Intishar Company, vol. 4, 5<sup>th</sup> edition, 1385 Solar Hijri Calendar) pp. 72-76. He believes that deposits before banks are governed by public law contracts but not by *mudaraba*, *wakala*, or *wadi’a*. As per Sharia and also the research theory, I would argue for *wadi’a/amana* as the legal essence of deposit accounts before financial institutions.

<sup>23</sup> For somewhat similar but very limited and arguable proposals in this regard see Zubair Hasan ‘Mudaraba as a Mode of Finance in Islamic Banking: Theory, Practice and Problems’ (MPRA, no. 2951, 2007) p.50. He suggests that the function of responding to short-term credit needs of trade has to be left to the conventional sort of banking, but for the long-term purpose of the finance industry, separate Islamic investment banks have to be set up. He also suggests the setting up of special schemes for the purpose of the development of entrepreneurial business between credit seekers and credit providers on the basis of Sharia principles.

<sup>24</sup> For more on the practice of *suftaja* (bill of exchange, letter of credit, etc) in Islamic finance see Subhi Y. Labib ‘Capitalism in Medieval Islam’ (Journal of Economic History, vol. 29, no.1, 1969) p. 89.

whether the two bank accounts belong to the same or two different customers.<sup>25</sup> In the modern world, undoubtedly, a debtor often needs an intermediary service to pay his debts to a creditor especially if his creditor is situated in a foreign jurisdiction. The most suitable instruments for the payment of debts or transfer of funds are *hiwala* (assignment/delegation), *aqd daman* (debt payment guarantee), and *wakala* (agency) arrangements. For example, consider that an investor (debtor) in London wants to pay his debt to another investor (his creditor) in New York. To arrange this payment, two PDI institutions (one in London and the other in New York) may get involved and different facilities may be used.

On the basis of *hiwala*, which would be a contract between the debtor in London and the PDI in New York, the debtor/investor in London transfers and delegates his debt payment obligation to the PDI in New York (to facilitate the process, a PDI in London will act as *wakil*/agent of the PDI in New York) and the PDI in New York agrees to pay the creditor/investor in New York. In other words, the creditor in New York agrees to receive his debt receivable from a third party payer i.e., a PDI in New York (also called *muhalun alayh*; delegee) instead of the original debtor in London. If it is presumed that upon the occurrence of *hiwala* (assignment) the debtor is discharged from his debt payment obligation towards the creditor and the creditor would only have a right of recourse to the third party payer i.e., the PDI in New York (as per the default rule in the *Shia* school of thought), to be a valid *hiwala* the consent of the creditor in New York is required. However, if it is presumed that the debtor is not discharged from his debt obligation towards the creditor (as per the *Sunni* school of thought), to be a valid *hiwala*, the consent of the creditor in New York is not required.

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<sup>25</sup> See *Royal Product Ltd. v. Midland Bank Ltd.* [1981] 2 Lloyd's L. Rep. 194 (QB) p. 198 and also Benjamin Geva 'Legal Aspects Relating to Payment by E-Money: Review of Retail Payment System Fundamentals' (Yearbook of International Financial and Economic Law, Vol. 5, pp. 255-272) p. 264.

In *hiwala*, in cases where a delegee, i.e., the PDI in New York, is not indebted to a *muhil*, then the debtor in London, the delegee, would have - after the payment- a right of recourse to the debtor over the amount of payment to the creditor. In cases where the debtor in London and the third party payer in New York (i.e., the delegee) become indebted to one another at the same time, a set-off would be effected and their debts would be annulled by *tahatur/muqassa*<sup>26</sup> (set-off) to the extent of the amount owed by the parties. Also, in cases where the creditor and the third party payer PDI in New York (i.e., the delegee) are indebted to one another at the same time, a set-off would be effected and their debts annulled by *tahatur/muqassa* (set-off) to the extent of the amount owed by the parties.

On the basis of an *aqd daman* arrangement, which is a contract made between the PDI in New York and the creditor in New York, the PDI in New York promises to the creditor in New York to satisfy the debt obligation of the debtor (i.e., the investor in London). In other words, in *aqd daman*, as in *hiwala*, the creditor in New York accepts receipt of his debt receivable from a third party payer i.e., the PDI in New York (also called *damin*; debt payment guarantor) instead of the original debtor in London. As per

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<sup>26</sup> Tahatur or Muqassa (set-off) is a debt settlement by a contra transaction. When two parties are indebted to one another, a set-off (tahatur or muqassa) will be effected regarding their mutual debts. Tahatur can only take place when the object of the debts are of the same nature and when their place and date of payment coincide, no matter what may be the cause of the debts (e.g., the cause of one debt may be a contract and the other a tort). For the purpose of tahatur, it is not necessary that the debts (from the outset) be created and receivable at the same time, but the requirement is that they have to be matured and duly receivable at the time of settlement. Tahatur is an automatic process which is effected without the necessity of the parties giving their consent. Thus when the parties are indebted to one another at the same time, their debts are annulled by tahatur to the extent of the amount owed by the parties and the parties to that extent are released and discharged of their debt obligations. Tahatur is not valid should it affect the indisputable rights and interests of third parties. Thus if an asset, which is owed by a debtor to a certain creditor, is legally seized in favour of a third party, and the debtor becomes a creditor against his original creditor, the debtor cannot invoke tahatur (automatic set-off) and refuse to pay the legally seized asset to the interested third party. Tahatur may be used for clearing, settlement, and netting of monetary obligations. See Iran Civil Code articles 294-299.

the default rule in the *Shia* school of thought, unlike the *Sunni* school of thought, upon the occurrence of an *aqd daman* the debtor in London is discharged of his debt obligation towards the creditor in New York and the creditor would only have a right of recourse to the third party payer i.e., the PDI in New York. In an *aqd daman*, a *damin* would have a right of recourse to the debtor after the payment, to the extent of the amount of payment to the creditor. In case the debtor in London and the third party payer PDI in New York (i.e., the guarantor) become indebted to one another at the same time, a set-off would be effected and their debts would be annulled by *tahatur/muqassa* (set-off) to the extent of the amount owed by the parties. Also, in case the creditor and the third party payer i.e., the PDI in New York are indebted to one another at the same time, a set-off would be effected and their debts would be annulled by *tahatur/muqassa* (set-off) to the extent of the amount owed by the parties.

On the basis of *wakala*, the PDI assumes no responsibility to pay the debt of the debtor (payer) and merely acts as a *wakil*/an intermediary (in return for a certain service fee, i.e., *haq al-wakala* paid by the payer), assuming the burden of transfer of the payment from the debtor/payer in London to the creditor/payee in New York. In this scenario, a *wakil* never takes the ownership of the funds while transferring them from the payer to the payee at any point of the clearing and settlement.

Moreover, PDIs may provide clearing, settlement, and netting services on the basis of *tahatur/muqassa* (set-off-like structure), *tabdil ta'ahhud*<sup>27</sup> (novation-like structure). PDIs may be appointed as the *wakil* (agent) of their account-holders or participants in exchange markets to automatically clear, settle, and net their debt receivables and obligations against each other using the principles of *muqassa*, *tabdil ta'ahhud* and also *sulh* (compromise).<sup>28</sup>

PDIs may also provide guarantee and suretyship facilities to their account-holders on the basis of an *aqd daman* (debt payment guarantee) or a *kifala* (personal surety arrangement). For example, in the case of credit sale transactions called *bay nasiya*, the supplier may ask for some proper assurances from the buyer. The PDI in which the buyer holds his accounts may provide the required assurances requested by the seller using *aqd daman* and *kifala* facilities.

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<sup>27</sup> *Tabdil Ta'ahhud* means conversion of a debt obligation to another obligation (novation-like structure). See Iran Civil Code articles 292-293. For more see also Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> edition, 1387 Solar Hijri Calendar) pp. 247-249, articles 292-293. Note that as per the laws of NY State, a novation requires the consent of the obligee and occurs when the parties (both the creditor and debtor) agree to change the original obligation by way of its replacement by a new obligation as substitute; thus releasing each other from the original obligations. They may agree to change the subject matter of the debt obligation (e.g., changing the obligation to deliver a commodity to a monetary obligation or replacing the immediate debt obligation by an obligation to deliver a certain amount of asset as substitute) or change the cause of the debt obligation (e.g., conversion of the obligation to pay the sales price or rental fees to a loan). By definition, it seems that an *aqd daman* (debt payment guarantee), *kifala* (personal surety) and *hiwala* (debt or credit assignment) are somewhat variants of *tabdil ta'ahhud*. Upon the occurrence of *tabdil ta'ahhud*, any securities attached to the original obligations of the parties will terminate, unless the parties agree on the survival of these securities. *Tabdil ta'ahhud* may be used for debt settlement and risk hedging purposes.

<sup>28</sup> It is worth mentioning that, like a *sulh* contract, *muqassa* and *tabdil ta'ahhud* may also be considered kinds of risk hedging tools.

### 6.3.2 *Sukuk* Intermediaries

*Sukuk* intermediaries are required to get involved in the process of *sukuk* issuance and also after their issuance. A *sukuk* intermediary, acting on the basis of *wakala* (agency), will handle the *sukuk* issuance between the issuer of *sukuk* and investors. For example, consider a farming company which expects to have some produce from its farms or livestock in the future but is struggling with some immediate debt obligations. The company can sell the produce in advance in cash using a *salam* facility to satisfy its current liabilities. For this purpose, the *sukuk* intermediary will purchase in cash the expected produce of the farming company (issuer) on behalf of the pool of investors, who will pay the purchase price. In this arrangement the *sukuk* intermediary can act as an agent (*wakil*) of both the issuer and prospective investors or there may be two intermediaries acting separately on behalf of the issuer and investors. The *salam sukk* holders who will then be considered upon the completion of the issuance the owner of the expected crops, cattle, meat or dairies can exchange or trade *salam sukk* in exchange markets. A further example would be: consider an owner of illiquid but valuable properties (such as a house or a storage facility) who wants to use them to discharge his current debt obligations whilst ensuring he has the opportunity to buy them back when good times return. The owner may sell these properties using *bay shart* or *bay wafa* (sale-with-repurchase-option) facility to a *sukuk* intermediary, who is acting on behalf of a pool of investors interested in the deal and willing to pay the purchase price. These properties, the ownership of which then belongs to the investors, will be leased for the time period of the *bay shart* contract to third party customers/lessees or the seller/issuer himself and the regular rental fees originating out of the leasing (*ijara*) transaction will be paid to the *ijara* (or *bay shart*) *sukuk* holders. This whole process (including issuance, payment, debt settlement, and execution of any legal documents) can be administered by *sukuk* intermediaries. The *sukuk* intermediary, like any other type of intermediary, is compensated with a certain

service fee and his compensation is not linked to the performance of underlying transactions which are administratively handled by the intermediary.

### 6.3.3 Liquidity Markets

*Sukuk* exchange markets need to be established in order to manage liquidity concerns by way of selling or exchanging (*bay* or *mua'wada*) any tradable *sukuk*, e.g., *musharaka sukuk* and *salam sukuk*.

The financial process in which the ownership value of underlying assets and property rights are transformed into and evidenced in the form of a document, which may then be exchanged in financial markets is called “securitisation”. It is argued that, in the Islamic world, the idea of securitisation can be traced back to the 7<sup>th</sup> century, when agricultural produce (crops) could be transformed into IOU documents (*sukuk*), resaleable by their holders (usually merchants) to third party investors. However, it is believed that the crops, which were the underlying assets of the *sukuk*, were to be harvested prior to the circulation and exchange of the *sukuk* to third party investors.<sup>29</sup> Some argue for more restriction on the negotiability of the *sukuk* and believe that the crops should first be actually possessed by the *sukuk* holders before they could transfer the *sukuk* to third parties.<sup>30</sup>

As per *Sharia*, those *sukuk* whose underlying assets are the fixed certain monetary assets such as fixed payments, debt receivables and cash flows cannot be traded against the fixed certain monetary assets denominated in the same currency

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<sup>29</sup> These scholars refer to the approval (indeed, non-objection/silence) of the Said ibn al-Musayyab in 712 (Solar Hijri Calendar) in this regard. See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 65.

<sup>30</sup> See Servet Bayindir ‘Menkul Kiymetlestirme Uygulamalari ve Fikihtaki Yeri’ (Istanbul Universitesi Ilahiyat Fakultesi Dergisi, XVI, 2007) pp. 260-261.



whether the trade occurs at a discount or a premium. However, they can be traded and exchanged against certain monetary assets denominated in different currencies<sup>31</sup> and also against non-monetary assets, including non-cash and non-fixed receivables whether they are tangibles, i.e., any types of goods and services or intangibles, i.e., unrealised non-fixed profits and intellectual property rights.

Major securities, i.e., the *sukuk* which may be exchanged in exchange markets, are termed shares. There is no *Sharia* impediment to the liquidity of a *musharaka* (partnership) and any partner in a *musharaka* may liquidate his shares (albeit, subject to the consent<sup>32</sup> of other partners). They may be exchanged in either regulated (stock- or securities-like) exchange markets or unregulated (OTC-like) markets. For example, participants (capital providers) in a venture capital enterprise may sell their shares at an OTC market, such as NASDAQ.<sup>33</sup>

#### **6.4 Best Western Intermediary Practices**

There are some best intermediary practices that are necessary to be adopted in the new alternative model with only minor changes in their structure and characteristics. These are not only successful and popular, but they are also largely consistent with the ultimate objective and theory of the model and Islamic law. These best practices are: commercial papers, documentary letters of credit, debit and credit cards, and agency.

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<sup>31</sup> As per some Islamic scholars, different currencies are treated as different assets and so their trade or exchange is permitted. See Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan' (Tehran: Sahami Intishar, vol. 1, 1387 Solar Hijri Calendar) pp. 341-342.

<sup>32</sup> This consent may, however, be granted in the Articles of Association of a *musharaka*/partnership.

<sup>33</sup> For the shares of a company to be tradable on NASDAQ, they must first be registered/listed with NASDAQ. Similar to NASDAQ, in the Islamic world, Malaysia launched the Malaysian Exchange of Securities Dealing and Automated Quotation in 1997.

### 6.4.1 Commercial Paper

A commercial paper is a document that calls for the payment of money (i.e., for satisfaction of a certain debt obligation).<sup>34</sup> There are only two types of negotiable instruments: a promissory note and a draft. A promissory note contains an affirmative promise to pay, and not just a mere “I owe you” (IOU). The promisor is called the maker and the promisee is called the payee. A draft contains an order or command to pay. A cheque is a typical draft. The person who gives the order is called drawer, the individual who is ordered to pay is called a drawee (typically, this is a bank), and the beneficiary of the order is called a payee. In order for a document like a commercial paper to qualify as a negotiable instrument, some requirements have to be met. It should be: in writing, payable to order or bearer, signed by the maker or drawer, for a certain sum, an unconditional promise and no additional promises, payable on demand or at a definite time, and payable in currency. If a negotiable commercial

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<sup>34</sup> This definition and also the explanation about commercial paper are provided according to Article 3 of the UCC (Uniform Commercial Code) USA. As another definition, for example, as per Kenneth V. Handal ‘The Commercial Paper Market and the Securities Acts’ (University of Chicago Law Review, Vol. 39, Issue 2, Winter 1972, pp. 362-402) pp. 363-364 and also Evelyn M. Hurley ‘The Commercial Paper Market’ (Federal Reserve Bulletin, Vo. 63, June 1977, pp. 525-536), commercial paper is defined as follows “commercial paper consists of unsecured, short-term promissory notes issued by sales and personal finance companies; by manufacturing, transportation, trade, and utility companies; and by the affiliates and subsidiaries of commercial banks. The notes are payable to the bearer on a stated maturity date. Maturities range from one day to nine months, but most paper carries an original maturity between thirty and ninety days. When the paper becomes due, it is generally rolled over that is, reissued to the same or a different investor at the market rate at the time of maturity”. It should be noted that in the US, as per *A.G. Becker Inc. v. Board of Governors of the Federal Reserve System*, 693 F.2d 136 (D.C. Cir. 1982), commercial paper is not considered a security under the Glass-Steagall Act.

paper is duly negotiated<sup>35</sup> to a holder in due course,<sup>36</sup> the holder in due course (and subsequent transferees who take “shelter” in that status) takes the instrument free of all claims to it, free of personal defences<sup>37</sup> and subject only to real defences.<sup>38</sup>

From a *Sharia* viewpoint, the legitimacy and legal nature of commercial paper can be analysed under the concept of *iqa'* (a legally binding act created unilaterally by one person).<sup>39</sup> Unlike a contract that requires a mutual asset, *iqa'* is created unilaterally by the intent and will of only one person. Significant types of *iqa'* in *Sharia* are *hiyazat mubah* (making an unusable public property usable such as rehabilitation of a public waste land), *khiyar* (an option of contract termination), *e'raad* (disregarding or leaving out a property or an interest), *ibra'* (waiver of a valid claim or a debt receivable), *tamalluk bi-Shuf'a* (an exercise of a pre-emption right), and *nadhr* (a vow that a person i.e., an oblationer dedicates). Of all these types, only *nadhr* relates to making a promise (others either relate to exercising a right or waiving a right). Therefore, the most suitable *Sharia* evidence to support the legitimacy of commercial paper (in which a promise is unilaterally made) is the concept of *nadhr*.

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<sup>35</sup> Due negotiation means there has been a proper transfer of the instrument. If the instrument has been properly transferred, the transferee is a holder and may be eligible to be a holder in due course. Otherwise, he cannot qualify as a holder in due course. When the instrument is payable to the order of a specific payee, it is negotiated by delivery of the instrument to that payee (named on the instrument). Any further negotiation requires that the payee endorses the instrument and delivers it to the transferee. The person who signs on the back of the commercial paper is called the endorser. Every endorsement must be either special or blank, and restrictive or unrestrictive. The special endorsement is one that names a particular person as “endorsee”. The endorsee must sign in order for the instrument to be further negotiated. The blank endorsement is one that does not name a specific endorsee. It may be negotiated by delivery alone. The restrictive endorsement contains a condition.

<sup>36</sup> A holder in due course (HDC) is a holder who takes the instrument for value; and in good faith; and without notice that it is overdue or has been dishonoured or is subject to any defense or claim.

<sup>37</sup> Personal defense equals every defense that is available in ordinary contract actions such as lack of consideration; unconscionability; waiver; estoppel; and fraud in the inducement.

<sup>38</sup> These real defences are: material alteration in terms of the instrument; duress; fraud in the factum (i.e., misinterpretation or lies about the instrument); incapacity; illegality; infancy; and insolvency.

<sup>39</sup> As per the Quran (17:34) “fulfill your promises/covenants”. Surely, the promise/covenant will be asked about (in the Hereafter”).

## 6.4.2 Documentary Letter of Credit (LC)

A documentary letter of credit (LC) is a legally-binding letter issued by a bank (called an opening or issuing bank) that guarantees independently the payment of the contract price to the seller/beneficiary (typically through instructing a corresponding bank, which can be its branches or other associated banks or agencies) or the acceptance of a bill of exchange on behalf of the buyer/applicant while assuring the buyer that the seller will not be paid until delivery of certain specified documents evidencing the proper shipment of relevant goods. A LC is an independent promise by the issuing bank and the payment obligation under the LC is not affected by any potential problems in the relationship between the buyer and seller as well as the buyer and issuing bank.<sup>40</sup> Today, documentary letters of credit are widely used to reduce payment risk in international business transactions due to some inherent problems surrounding international trade environment especially the difficulty in knowing different foreign laws and also the difficulty in meeting each other (i.e., the parties to a given international transaction) personally. Expressed by English judges as “the life blood of international commerce”<sup>41</sup>, a documentary letter of credit allows a buyer in a business transaction to substitute its financial relationship with that of a reliable and stable credit source, normally a bank.<sup>42</sup> Documentary Letters of credit is

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<sup>40</sup> With regard to the legal essence of a letter of credit, as per Dalhuisen, a LC is indeed neither letter nor credit, but rather an unconditional and (a double) independent promise of payment by the issuing bank. The most important exception to the payment obligation of the issuer is fraud. Mistakes may also render the payment obligation of the issuer void. See Jan H. Dalhuisen ‘Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law’ (Hart Publishing, vol. 3, 4<sup>th</sup> edition, 2010) pp. 372-390.

<sup>41</sup> See for example Kerr in *R. D. Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] Q. B. 146 p. 155; Hirst in *Hong Kong and Shanghai Banking Corporation v Kloeckner & Co AG* [1989] 2 Lloyd’s Rep. 323 p. 330; and also Griffiths in *Power Curber International Ltd v National Bank of Kuwait S. A. K.* [1981] 2 Lloyd’s Rep. 394 p. 400.

<sup>42</sup> See *Banco General Runinahui Sa v Citibank International Na Rm*, 97 F.3d 480 (11th Cir. 1996) and also *Alaska Textile Co., Inc v Chase Manhattan Bank, N. A.*, 982 F.2d 813, 815 (2d Cir. 1992).

governed by the Uniform Customs and Practices for Documentary Credits (last version is known as UCP 600), which is a set of rules drafted and published by the Paris-based International Chamber of Commerce (ICC). Ever-increasingly, the newest versions of UCP favor trade customers over banks, thus causing an ever-decreasingly use of the UCP rules by banks, comparing to previous versions.<sup>43</sup>

The legitimacy of documentary letters of credit under *Sharia*, in particular according to the viewpoint of the *Shia* school of thought,<sup>44</sup> may be supported by the concepts of *aqd daman* (debt payment guarantee) and *hiwala* (assignment of debt obligation).

### 6.4.3 Debit and Credit Card

A debit card is a withdrawing and payment card issued by the bank of a depositor that enables the holder of a deposit to withdraw money or to have the cost of his purchases and shopping charged directly to his bank account held with that bank. A credit card, in contrast, that is issued by a bank or a business enables the holder to purchase goods or services on credit while assuring a supplier that the person using the credit card has an adequate credit rating and that the supplier of goods or services will definitely receive payment for the goods or services provided to the credit card

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<sup>43</sup> See William Banks Sutton 'The Documentary Credit Phoenix: UCP 600 Boasts Fair Rules for Trade Customers, Hard Rules for Banks' (DAJV Newsletter, Vol. 37, Issue 2, June 2012, pp. 62-65) p. 62.

<sup>44</sup> According to the Shia school of thought, unlike the view of the Sunni school of thought, upon the execution of *aqd daman* or *hiwala* the original debtor is released from his debt obligation toward the creditor, and instead the guarantor (*damin*) or delegee (*muhāl alayh*) becomes obligated to satisfy the relevant debt obligation.

holder. Traditionally, credit cards are either bipartite or tripartite.<sup>45</sup> With respect to bipartite credit cards, there is basically a direct contractual relationship between the credit card issuer and the credit card holder.<sup>46</sup> Regarding tripartite credit cards, there is generally a series of relationships among a credit card issuer, credit card holders, and suppliers.<sup>47</sup> Retail payment systems (i.e., payment by credit and debit cards) could operate either in the form of “credit-push” or “debit-pull” systems. In a credit transfer a message from the payor is communicated to the payor’s bank to “push” the funds from the payor’s account to the payee’s account. Conversely, in a debit transfer, instructions are given by the payee to the payee’s bank to “pull” the funds from the payor’s account. Therefore, in a credit transfer, the sender of the first message is the payor; in a debit transfer, conversely, it is the payee.<sup>48</sup> From a commercial viewpoint, a distinction is made between debit cards and credit cards. Credit cards grant card holders a period over which payments regarding the expenses occurred as a result of using these cards can be settled. With respect to debit cards, which are the latest development to the range of “plastic money”, the debit card holder must have an enough positive balance on her debit card account to cover any expenses incurred as a result of using the card. Payment by debit card is processed in the same way as payment by credit card, with only exception that the credit card issuer debits the

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<sup>45</sup> See Steve Cornelius ‘The Legal Nature of Payment by Credit Card’ (South African Mercantile Law Journal, Vol. 15, Issue 2, 2003, pp. 153-171) p. 153 (Citing RE de Rooy Betalingsverkeer (Gegarandeerde Betaalmiddelen) (1989) 6; Otto op cit note 1 at 217 et seq; JC Stassen ‘Betaling deur Middel van ‘n Driepartykredietkaart’ (1978) 11 De Jure 134 at 135).

<sup>46</sup> See Steve Cornelius ‘The Legal Nature of Payment by Credit Card’ (South African Mercantile Law Journal, Vol. 15, Issue 2, 2003, pp. 153-171) p. 153 (Citing SR van Jaarsveld & MJ Oosthuizen (eds) Suid-Afrikaanse Handelsreg vol II 3 ed (1988) 141).

<sup>47</sup> For more detail regarding these tripartite contractual relationships see Catherine Smith ‘Credit Cards and the Law’ (Journal for Contemporary Roman-Dutch Law known as THRHR, Vol. 52, 1976) p. 110.

<sup>48</sup> See Benjamin Geva ‘The EFT Debit Card’ (Canadian Business Law Journal, Vol. 15, 1989) pp. 419-427 and also Benjamin Geva ‘International Funds Transfers: Mechanisms and Law’ in Cross-Border Electronic Banking (2nd edition, London, Hong Kong: LLP, 2000) p. 1.

credit card holder's account with the relevant amount of expenses incurred.<sup>49</sup> Apart from its primary function as a mode of payment, credit cards can also be utilised to withdraw cash from ATMs. They also have a cheque guarantee function- that is to say the card holder can, complying with a set arrangement, guarantee payment of cheques up to a specific amount.<sup>50</sup>

From a *Sharia* perspective, the legitimacy of debit card services is substantially supported by the *wadi'a* or *amana* (safe-keeping of a deposit) concept. As per *Sharia*, unlike debit cards which have to be issued by a deposit-taking body such as banking institutions in modern practices, credit cards can only be issued by the relevant suppliers or retailers using *murabaha* (cost plus mark-up sale) facility. The reason why the banks cannot issue credit cards is that banks do not want to or are not generally authorised to engage in real economic and business activities. However, credit cards may also be issued by banking institutions using the arrangements of *aqd daman* (debt payment guarantee) or *hiwala* (assignment of debt obligation) where no interest or mark-up can be charged on the credit card holder.

#### 6.4.4 Agency

Agency is another very important intermediary concept and has been discussed earlier. In brief, agency is an informal agreement between two parties (i.e., principal and agent) whereby the agent undertakes to conduct certain affairs for the principal's interest while the principal retains the right to control the agent, by having the

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<sup>49</sup> See Tony Drury and Charles W. Ferrier 'Credit Cards' (Lexis Law Pub, 1984) pp. 6-7.

<sup>50</sup> See Steve Cornelius 'The Legal Nature of Payment by Credit Card' (South African Mercantile Law Journal, Vol. 15, Issue 2, 2003, pp. 153-171) p. 155.

authority to supervise the manner of the agent's performance.<sup>51</sup> Today, agency is widely used in many areas from politics to international commerce and from the banking sector to capital markets. The practice of independent and professional intermediaries is a key element in running proper political, economic, business, and financial systems. As per *Dalhuisen*<sup>52</sup>, true agency happens when an intermediary merely initiates or fulfils a legal act or obtains discharge for someone else but does not act for his own account, that is to say, does not take risks or acquire benefits of his own. With regard to the legal essence of agency, according to him, "these intermediaries [i.e., agents] may act as mere service providers but also as true agents, which means that in the exercise of their function as intermediaries they fulfill legal acts for others, in this case for the contractual parties". The source of the agency relationship may be consensual<sup>53</sup> or contractual<sup>54</sup>. In some situations, agency

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<sup>51</sup> This definition is widely accepted in US law especially New York State Law. As per another definition, for example, provided by some scholars "commercial intermediation represents the activity that one person executes either in the name and on behalf of another person, or using its own name but on behalf of another person, or, finally, using its own name but on behalf of acting toward a common goal with the person who mandated her (the principal), in relation with who it is either a proxy or an independent intermediary, only negotiating or both negotiating and binding the principal." See Dan-Alexander Sitaru 'Considerations regarding the Definition and Classification of Commercial Intermediation' (Lex ET Scientia International Journal, Vol. 18, Issue 1, 2011) p. 97. As per Sitaru (citing R. Munteanu 'Intermediation Contracts in Romanian Foreign Commerce' - *Contracte de Intermediere in Comertul Exterior al Romaniei*- (Printing House of the Academy of the Romanian Socialist Republic, 1984, p. 138)), a common feature of all types of intermediation is the "object" of the intermediation, that is to say, by means of the performed activity under a specific commercial intermediation contract, the intermediary acts as an agent for specific commercial activities between certain partners or on behalf of another person (i.e., client), in return for certain payment.

<sup>52</sup> See Jan H. Dalhuisen 'Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law' (Hart Publishing, vol. 2, 4<sup>th</sup> edition, 2010) pp. 231-232.

<sup>53</sup> See, e.g., *Garnac Grain Co. Inc. v. H. M. F. Faure & Fairclough Ltd.*, [1968] A.C. 1130 at 1137, as per Lord Pearson (H. L.)

<sup>54</sup> See, e.g., *Pole v. Leask* (1860) 28 Beav. 562 at 574; (1860) 54 E.R. 481 at 486, as per Lord Romilly, M. R.



relationship may emerge from the conduct of the party eventually held to be the principal as a result of his conduct.<sup>55</sup>

The terms used instead of common law “agent” or “agency” concepts are “representative”, “power of representation”, and “authority” in civil law. The latter terms are used where an authorised person acts merely on behalf of the relevant authorising person without taking any risk and incurring an own liability. The authorised person plays a role of middleman who receives only a commission in return for the provision of some specific services. These terms must in turn be distinguished from some other terms, which purport to have exactly the same meanings but indeed do not, such as; licensees, sole distributors, and some franchising agents who all deal for their own benefit. There are other types of intermediaries who sometimes act merely on behalf of their authorising clients, but also in some cases for their own account such as securities brokers in exchange markets and also central counterparties (CCPs) in modern clearing systems. It is thus concluded that not every intermediary or so-called agent is a true agent in the sense of fulfilling legal acts or acquiring a release for someone else.<sup>56</sup>

In *Sharia*, the legitimacy of agency is based on either *wakala* (legal or administrative agency) or *mudaraba* (commercial agency) concepts. If the purpose of the intermediary is to fulfil legal or administrative acts, or obtain discharge for others in return for a service fee (*haq al-wakala*), it is based on *wakala* (legal or administrative agency). The purpose in *wakala* is not to basically make profit by using the professional services of a *wakil* (agent). In contrast, in cases where the purpose is to make profit by using the expertise, talent, and professional services of an intermediary, it will be based on *mudaraba* (commercial agency). In *mudaraba*, the

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<sup>55</sup> See *Pole v. Leask* (1863) 8 L.T. 645 at p. 648, as per Lord Cranworth.

<sup>56</sup> See Jan H. Dalhuisen ‘Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law’ (Hart Publishing, vol. 2, 4<sup>th</sup> edition, 2010) pp. 231-232.

intermediary (*mudarib*) shares in the profits earned pro rata in accordance with his contribution to the business. Due to conflict of interest concerns, these two roles (i.e., *wakala* and *mudaraba*) are not capable of being conducted by one intermediary at the same time.

## **Chapter Seven:**

# **Part Seven of the Second Tier of the Model (7): Risk Hedging Facilities**

## 7.1 Introduction

Historically, in the Islamic world, insurance was first developed for personal liabilities in the form of *kafala/takaful* or *a'qila* and later came to include loss and damage to property. *Kafala* was an insurance scheme on a tribal level and *a'qila* was on the familial level. In the pre-Islamic Arab world, when a member of a tribe was killed by a member of another tribe, the entire tribe to which the murderer belonged was put at risk of a revenge attack by any member of the tribe to which the victim was linked. To solve this problem, the concept of *kafala* was introduced. As per *kafala*, *kafil* (a surety) ensured the presence of the killer in the place designated by the tribe of the victim whenever summoned by them and, if the *kafil* was unable to meet his undertaking, he was obliged to compensate the loss of life of the victim by paying blood money known as *diya*<sup>1</sup> to the tribe of the victim. For the purpose of this compensation, a fund was often established and the members of the defendant tribe contributed an asset to this fund. The collected fund could be used either to pay the *diya* (blood money) or to settle any other tribal dispute. It could even be used to release any member of the tribe who had been captured by another tribe. This support at the tribal level was later reduced to a familial level called *a'qila*. As per the *a'qila* facility, only paternal relatives of the culprit (but not all members of the tribe) shared liability to compensate the victim's family.<sup>2</sup> According to *Hamidullah*,<sup>3</sup> the continued use of these pre-Islamic Arab customs was confirmed by the Prophet and they were included in the first constitution. It is clear that *kafala* and *a'qila* were introduced to

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<sup>1</sup> This concept is also found in the Quran (2:178, 4:91, and 5:48).

<sup>2</sup> For some details as to the practice of *kifala* and *a'qila* see Mohd Ma'sum Billah 'Applied Takaful and Modern Insurance' (Kuala Lumpur: Sweet and Maxwell Asia, 3<sup>rd</sup> edition, 2007) p. 6. As per Billah (p.8), during the Government of Omar, Muslims were encouraged to practice *a'qila* at a national level.

<sup>3</sup> See Muhammad Hamidullah 'The First Written Constitution in the World' (Lahore: Sheikh Muhammad Ashraf, 1981) p.55, article 3.

reduce the risk of insecurity, to transfer individual risk to a collective burden, and also to spread the spirit of cooperation among the members of the society (at least at the tribal and familial level). As far as the early practice of property insurance is concerned, Muslim sailors in the past maintained trade links between the large economies in the Indian Ocean and Mediterranean Sea through sailing the dangerous trade routes. There was a tradition of helping one another on the basis of *ta'awun* (mutual assistance)<sup>4</sup>. It is very likely that the ship owners established and contributed to mutual coverage of maritime insurance funds to jointly share the burden of any its members and compensate the member who incurred losses. Looking at the practice of insurance schemes in Islamic history makes it clear that the existence of hedging or insurance was there to minimize rather than take advantage of risk. That is why taking advantage of risk by trading it may be one of the main arguments against the legitimacy of conventional risk insurance products and institutions.

The main concepts that support the recognition of insurance in Islam are: *ta'awun* (mutual assistance), *tabrru* (voluntary contribution), and *kafala* (personal surety).<sup>5</sup> From the Islamic viewpoint, insurance is forbidden if it is used to cover risks in *qimar* (gambling)<sup>6</sup>, *maysir* (speculation/betting), and *riba*-bearing activities which are all clearly prohibited in the *Sharia*. *Maysir* (speculation/betting) and *qimar* (gambling) have two basic elements which prohibit them: *gharar* (excessive uncertainty) and *khatar* (disproportionate risk). In other words, the presence of *khatar* and *gharar*

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<sup>4</sup> See the Quran (5:3).

<sup>5</sup> See the Quran (5:2) "help one another in righteousness and also piety, but do not help one another in sin and rancour".

<sup>6</sup> See the Quran (5: 90 & 91): "O believers! ... Gambling and games of chance ... are all abominations, the handiwork of Satan. So turn wholly away from them in order that you may attain true success. By ... games of chance and gambling... Satan wants only to excite and create enmity and hatred between you. So, will you not then abstain?"

prohibit games of chance and speculative activities.<sup>7</sup> Some scholars may argue that it is because of *khatar* and *gharar* that conventional insurance schemes should also be ruled illegitimate. However, it seems this argument is not solid enough to rule the conventional insurance practices illegitimate. The reason for this is that the salient feature of the insurance contract is the “provision of security”, which is a known consideration, by the insurer in return for a certain contribution by the insured which is also a known consideration called a “premium”.<sup>8</sup> Neither of the considerations include the *khatar* or *gharar* elements. The purpose of the insured is to be secured against the potential risks and damages no matter how much the damages amount to (or whether the risk event will occur at all) and his basic purpose is not to gain profits from the insurance contract. Another concern that may be raised as to the legitimacy of modern insurance practices is that the insurance firms are often involved in lending or borrowing transactions at fixed interest, which is a prohibited *riba* dealing according to *Sharia*. However, this *riba* element is not in the insurance contract itself and it can

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<sup>7</sup> For a definition of *khatar* and *gharar* (in an insurance context) see Muhammad Imran Usmani ‘Issues in Takaful’ (SECP Takaful Conference, March 14, 2007). *Khatar* means: a) to stipulate or conditionalise the ownership or profitability on an uncertain event, where a stake is involved for both sides. However, if a stake is not involved from both sides i.e. one party voluntarily (without any compensation) declares “I shall compensate you on a particular event of loss”, it would not be *maysir*; b) if in any transaction one party’s profit is dependent on the loss of the other then this is an indication that the transaction involves *qimar* and one party is being exploited by the other. In the permissible modes of business any profit or loss will be equitably shared and will be fair to every party. For example, in a partnership (*musharaka*) both parties share profit and loss (a win-win or lose-lose game). Similarly in other transactions like sale (*bay*), hiring or leasing (*ijara*) each party gains some specific consideration. *Gharar* literally means “uncertainty”. Forms of *gharar* are: a) any bilateral transaction in which the liability of the party to the transaction is either uncertain or contingent; b) consideration to either party is not known; c) delivery is not within the control of the obligor; d) payment (or satisfaction of any obligation) from one side is certain, but from the other side is contingent. As can be seen, *gharar* is generally a concern in contractual relationships.

<sup>8</sup> For a similar idea see Murtaza Mutahhari ‘Mas’alaye Riba wa Bank (bi Dhamimeye Mas’alaye Bime)’ (Tehran: Sadra Publications, 14<sup>th</sup> edition, 2005) pp. 129-133 and 145-147. Also, see Murtaza Mutahhari ‘Barrasiye Ijmaliye Mabaniye Iqtisade Islami’ (Tehran: Hikmat Publications, 1<sup>st</sup> Edition, 1982) pp. 259 and 300-302.

be avoided if the insurance firm's funds are not used in *riba*-bearing investment activities and the firm does not borrow *riba*-bearing loans.

Any risky aspect of a reasonable and legitimate business or financial transaction can be hedged using either a human collateral such as *aqd daman* (debt guarantee) and *kifala* (personal surety) or a capital collateral such as *rahn* (collateral), *daman uhda* (guaranteeing legal concerns pertaining to a given property) or *daman darak* (guaranteeing physical and economic concerns pertaining to a given property). It is worth adding that *rahn* (as per both *Sunni* and *Shia* schools of thought) and also *aqd daman* and *kifala* (as per the *Sunni* school of thought) are subordinate contracts and they are terminated automatically upon the fulfilment or termination of the original obligation, which has been the cause and underlying reason for *aqd daman*, *kifala*, or *rahn*.

Last but not least, it may be argued that the purpose of the parties to the insurance contract, namely, the insurer and the insured is to make a compromise (*sulh*)<sup>9</sup> - the compensation of damages (if any) in return for a premium. As per *Sharia*, it is legitimate to make a compromise if the subject matter of the compromise (*sulh*) is a legitimate, reasonable, and beneficial act.<sup>10</sup>

As far as the Western approach to risk and insurance concerned, according to some scholars e.g., Baker<sup>11</sup>, western society is "embracing risk" in two different senses. First, members of the public, to a greater extent, use notions of risk to explain and deal with social problems such as money management, social services and environmental problems. This feature of the idea of "embracing risk" is incontrovertible. Later experiences such as September 11 that raised the profile of the risk of terrorism and

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<sup>9</sup> Sulh means a settlement of the existing or future differences in which each party to the (insurance) contract makes concessions.

<sup>10</sup> See Iran Civil Code articles 754 and 215.

<sup>11</sup> See Tom Baker 'Embracing Risk, Sharing Responsibility' (Drake Law Review, Vol. 56, Issue 2, 2008) p. 562.

justified the necessity to begin war in Iraq due to the risks created by weapons of mass destruction and also Hurricane Katrina that put catastrophic risk on the national agenda only reinforce the assertion. Second, Western world has not only embraced risk as a helpful conceptual framework, but has also considered taking of risk as a social policy tool. Across Western world, states, large corporations, and other big organisations that used to spread risks are inducing and sometimes exposing individuals to take more real risks and become more individually responsible- all allegedly for the sake of creating a more dynamic and innovative society. This second feature of embracing risk is more contentious. As per Baker, the main idea here is the acknowledgment that “too much protection against loss can produce too much loss. Not all risks should be spread. For their own and society’s good, individuals should embrace some risks”. In conclusion, Baker<sup>12</sup> argues for “embrace risk, but share responsibility” approach in the 21<sup>st</sup> century. “United we stand; divided we fall”. According to this vision, first, insurance providers should adapt to enhance the motivations for individuals and institutions to prevent damage from happening. That is the part of “embracing risk”. But simultaneously, regulatory policy should be conducted in a way to prevent the damaging competition and “depooling” that will otherwise happen. That is the “sharing responsibility” part. Second, insurance providers have to adapt to embrace or provide insurance for unforeseeable, catastrophic risk. That is the “embracing risk” part. Also, the capacity of overall insurance system has to be increased to make good assessments by a governmental support or in other new ways that lawyers and policymakers may introduce. That is the “sharing responsibility” part.

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<sup>12</sup> See Tom Baker ‘Embracing Risk, Sharing Responsibility’ (Drake Law Review, Vol. 56, Issue 2, 2008) pp. 569-570.



## 7.2 Facilities

The following are the major instruments that can be used for risk hedging and insurance purposes.

### 7.2.1 Collateral (*Rahn*)

*Rahn*<sup>13</sup> is a contract whereby a debtor (*rahin*) gives a property called *marhuna* whether it be movable or immovable (the collateral) to the creditor (*murtahin*) as security. The collateral will be utilised to settle the debt if the *rahin* defaults on the debt. No property or asset which is legally incapable of being alienated or transferred can be the subject of *rahn*. Collateral can be in any form of tangible or intangible assets which is capable of being exchanged or negotiated. There are some Islamic scholars<sup>14</sup> who argue that collateral has to be a specific tangible asset (i.e., an ascertained object; *ayn*) and if it is an intangible asset or yet-unrealised asset (e.g., usufruct of a property or debt receivables) *rahn* would be null and void; however, they believe that collateral can be in the form of bearer securities e.g., bearer shares or currencies. The ownership of collateral and the benefits arising out of collateral during a *rahn* contract would belong to the debtor. Debtor and creditor may agree in the *rahn* contract that the benefits arising out of collateral, instead of being returned to the debtor, would be retained by the creditor as additional collateral in addition to the original collateral. All the risks associated with the ownership of collateral will be borne by the debtor. The

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<sup>13</sup> For more detail on *rahn* see Nasser Katouzian 'Qanun Madani dar Nazm Huquq Kununi-ye Iran' (Tehran: Mizan publication, 18<sup>th</sup> Edition, 1387 Solar Hijri Calendar) pp. 477-491, articles 771-794.

<sup>14</sup> For a detailed discussion in this regard from the viewpoint of Sharia see Nasser Katouzian 'Huquq Madani: Uqud Mu'ayyan' (Tehran: Sharkat Sahami Intishar, vol. 4, 5<sup>th</sup> edition, 1385 Solar Hijri Calendar) pp. 539-547, no. 353. Also, see Hasan Imami 'Huquq Madani' (Tehran, vol. 2, 3<sup>rd</sup> edition) p.338. For a regulatory supporting authority in this regard see Iran Civil Code article 774.

creditor would not be responsible for the decay or deterioration of collateral, unless it occurs as a result of the negligence of the creditor. Collateral may be pledged<sup>15</sup> or mortgaged<sup>16</sup> in respect of two or more debts that the debtor owes to two or more creditors. In that case the creditors have to agree among themselves as to who shall take the collateral in possession;<sup>17</sup> similarly, it is possible for two or more debtors to give a property as joint collateral to a creditor to whom they owe debts. The creditor who holds collateral has a preference over every other creditor in the recovery of his claim from the value of the collateral. In a *rahn* contract, or by incorporation in a separate contract, a debtor may appoint a creditor or a third party as his agent (*wakil*) to ensure that if the debtor defaults in the payment of his debt, the appointed *wakil* (whether it is the creditor himself or the third party) will have the power to recover the debt from the collateral itself or from its sale price. In cases where the collateral is sold at a price greater than the amount of the claim of the creditor, the excess would belong to the owner thereof (i.e., *rahin*/the debtor). If, on the contrary, the proceeds of the sale are less, the creditor will have a right of recourse to the debtor for the balance. In this case, to recover the balance, if the debtor has become insolvent or bankrupt, the creditor (having no preferential right) will have to share it with the other creditors of the bankrupt debtor. The debtor may not engage in any legal (e.g., to transfer the ownership of collateral or to lease the collateral) or non-legal act with regards to the collateral, that could be contrary to the rights of the creditor, unless it is

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<sup>15</sup> Pledge in this instance means a security interest in a movable property.

<sup>16</sup> The term mortgage refers to a security interest in an immovable property.

<sup>17</sup> Note that the continuity of possession of collateral by the creditor is not necessary. Collateral may be, after it is pledged or mortgaged, substituted with other collateral with the mutual agreement of the debtor and creditor.

done with the permission of the creditor.<sup>18</sup> Obviously, *rahn* is used for risk hedging and security purposes.

### 7.2.2 Debt Payment Guarantee (*Aqd Daman*)

*Aqd daman*<sup>19</sup> is a contract of guarantee whereby a third party guarantor called a *damin* assumes responsibility for the debt obligation of the debtor to a creditor (beneficiary) if the debtor fails to pay or fulfil his debt obligation.<sup>20</sup> This concept is also applicable where a guarantor underwrites any claim and obligation (pertaining to an asset) that has to be fulfilled by an owner of the asset. *Aqd daman* is a legally-binding contract only between the guarantor and creditor and the consent of the debtor is not required. As per the *Sunni* school of thought, the default rule in *aqd daman* is that the debtor and guarantor will be jointly and severally responsible towards the creditor (beneficiary). In contrast, as per the *Shia* school of thought, the debtor will be discharged and released from his debt obligation and instead, the guarantor will be solely responsible towards the creditor.<sup>21</sup> Therefore, for example, as per the latter school of thought but unlike the former, if after *aqd daman*, the beneficiary (creditor) becomes indebted to a debtor, this fact will not release the beneficiary from his debt

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<sup>18</sup> In cases where the possession of collateral has been granted to the debtor by the creditor, the opinions of Islamic scholars are divided on whether the debtor is permitted to lease the collateral to a third party or not; that is to say, whether this act would be contrary to the rights of the creditor or not. It seems that the debtor can lease the collateral. Moreover, it seems it is not contrary to the rights of the creditor when the debtor re-pledges or re-mortgages the same collateral to another creditor; however, the first creditor will have a priority right over the collateral.

<sup>19</sup> For more detail on *aqd daman* see Iran Civil Code articles 684-723.

<sup>20</sup> It is worth noting that, since the capital collaterals i.e., the pledges, collaterals, property mortgage and also the sale-with-repurchase-option contracts were not customarily in practice in the early Islamic period, the human collaterals i.e., debt guarantee and personal surety contracts were very important and widely used in business transactions. See Muhammad Ja'far Jafari Langroodi 'Maktabhaye Huquqi dar Huquq-e Islam' (Tehran: Ganj-e Danesh, 3<sup>rd</sup> edition) pp. 200-201.

<sup>21</sup> That is why in the *Sunni* school, unlike the *Shia* school, joint and several responsibility is generally accepted in the realm of contractual guarantees.

against the debtor and so the mutual debts, if any, of the beneficiary and debtor will not be subject to *tahatur* and *muqassa* (automatic set-off). In short, *Sunnis* have taken a creditor-friendly and debtor unfriendly approach unlike the *Shias*, who have adopted the reverse approach. In *aqd daman*, a second guarantor may further guarantee the fulfilment of obligation of the (first) guarantor. Also, in *aqd daman*, for assurance purposes, the creditor (beneficiary) may ask for a provision of collateral from the guarantor, even though no security was attached to the original debt. A guarantee in respect of a debt whose legal or contractual cause has not yet arisen is null and void. In a matured or an overdue debt it is possible for the guarantor to guarantee its payment on a specific future date; and similarly for an immature debt he can assume its payment immediately. To make *aqd daman*, in and of itself, dependent upon certain factors is void: for example, I (the guarantor) shall stand as guarantor, if the debtor does not pay his debt. However, it is possible to make execution of the guarantee (i.e., fulfilment of debts) dependent upon certain factors. The guarantor has no right of recourse against the guaranteed debtor until after the payment of the debt; but he can have recourse if the guaranteed debtor has undertaken to obtain release for the guarantor within the specified time, and that time has elapsed. If the guarantor, with the consent of the beneficiary, transfers the obligation of payment of the debt to another, and if that person accepts to pay it, it is as though the guarantor has paid the debt, and he has a right of recourse against the guaranteed debtor. The same rule is applicable when the beneficiary (creditor) assigns his claim against a guarantor to another person and that person agrees to collect it from the guarantor. If the guarantor pays the beneficiary (creditor) less than the debt, he cannot claim from the guaranteed debtor more than what he has paid, even if he has compromised (*sulh*) for less than the amount of the debt. Similarly, if the guarantor pays the beneficiary more than the debt, he has no right to claim more, unless he has paid it with the permission of the guaranteed debtor. Furthermore, if the debt is payable at the end of a term, and

the guarantor pays it before the due date, he cannot claim it from the debtor as long as the period of the debt has not yet elapsed. The guarantor has no right of recourse against the guaranteed debtor under the following circumstances: a) the beneficiary/creditor discharges the guarantor to pay the guaranteed debt; b) a third party freely pays the guaranteed debt; and c) the guarantor guarantees the payment of debt for some spontaneous benevolent reason. If numerous guarantors guarantee a debt on a pro rata basis, the beneficiary (creditor) has the right of recourse against each one of them to the extent of their share only; and if one of the guarantors pays the whole of the debt he can then refer to other guarantors who agreed to the payment, to the extent of their share only. In cases where the share of each guarantor is not known, it is presumed that they have assured the payment of debt in equal shares. In such a guarantee-sharing arrangement, there would be no legal or contractual relationship between guarantors, and they are treated independently of each other and do not represent each other in respect of the payment of the guaranteed debt. A guarantor of a guarantor has no right of recourse against the original debtor, but must refer to the person whom he has guaranteed; and in the same manner every guarantor has recourse against his own guaranteed guarantor/debtor and so on up to the original debtor. As per the *Shia* school of thought, the default rule is that the creditor (beneficiary) would have a right of recourse only against the last guarantor and all guarantors before the last guarantor as well as the original (guaranteed) debtor are released upon each relevant *aqd daman*. In contrast, as per the default rule of the *Sunni* school of thought, the creditor (beneficiary) would have a right of recourse against all guarantors as well as the original debtor jointly and severally. *Aqd daman* is also often used for risk hedging purposes.

### **7.2.3 Guaranteeing Legal and Economic Risks of an Asset (*Daman Uhda* and *Daman Darak*)**

The subject matter of an *aqd daman* may be extended to cover an *ayn* (an ascertained asset e.g., a house) rather than a *dayn* (a debt receivable). In this circumstance, the insurer assures an owner against the physical and economic losses and also the legal risks pertaining to the ascertained asset.<sup>22</sup> According to Islamic scholars, this guarantee over the legal risks pertaining to an asset is called a *daman uhda*, and the guarantee over the economic losses pertaining to an asset is called a *daman darak*.<sup>23</sup> According to the former circumstance, i.e., *daman uhda*, the insurer ensures the owner regarding any legal problems pertaining to the given asset, e.g., ensures that the property purchased by the insured (buyer) was legally owned by the seller at the time of the sale. As per the latter, i.e., a *daman darak*, the insurer guarantees the quality and safety of the given property. Hence, it may be argued that the subject matter of an *aqd daman* could be any belongings of the insured whether they are tangible or intangible assets. Because of this it may also cover health, safety, and environmental concerns.

### **7.2.4 Personal Surety (*Kifala*)**

*Kifala* (suretyship/personal surety)<sup>24</sup> is a contract by virtue of which one person called a *kafil* (surety) ensures the presence of a third person called a *makful* (obligor)

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<sup>22</sup> Supporting evidence for this argument can be found in the Iran Civil Code articles 390-393 which is grounded in Sharia rules and principles.

<sup>23</sup> See Murtaza Mutahhari 'Mas'alay-e Riba wa Bank (bi Dhamimeye Mas'alay-e Bime)' (Tehran: Sadra Publications, 14<sup>th</sup> edition, 1384 Solar Hijri Calendar) pp. 146-147. Also, see Murtaza Mutahhari "Barrasiye Ijmaliye Mabaniye Iqtisade Islami" (Tehran: Hikmat Publications, 1<sup>st</sup> edition, 1403 Lunar Hijri Calendar) pp. 301-302.

<sup>24</sup> For more detail on *kifala* see Iran Civil Code articles 734-751.

before somebody else called a *makfulun lah* (obligee) when summoned by the *makfulun lah* (obligee). The difference between an *aqd daman* and a *kifala* is that in the former the given assurance is to ensure the payment of a debt receivable owed by the debtor to the creditor, but in the latter the given assurance is to ensure the presence of the debtor/obligor as per the request of the creditor/obligee for the satisfaction of his obligations. Another major difference is that a guarantor (*damin*) can only secure the realised debt, but a surety (*kafil*) is able to secure even a contingent claim. To be a valid *kifala* it is not necessary for there to exist a lawful claim incumbent upon the obligor; the existence of a reasonable claim by the obligee against the obligor is sufficient, even if the obligor denies it. The surety must make the obligor be present at the time and the place where he has promised; otherwise he must incur the obligation which is incumbent on the obligor. However, if the surety has undertaken to pay a certain compensation if the obligor does not appear at the time and the place as he has promised, the surety must act in accordance with his undertaking.<sup>25</sup> In the same way as *aqd daman*, it is possible for another person to become a surety of a surety. If a person is a surety of a surety, and another person in turn becomes his surety, and so on, each surety would be obliged to make the obligor (or surety) pertaining to him, to be present at the time and the place where he has promised to do so. Whichever of the suretys makes the original obligor present before the original obligee will be discharged together with all the other suretys; and whichever of suretys becomes discharged by any reason, the suretys who come after him are discharged too. If a *kifala* is done with the permission of the obligor, and the surety, not being able to make the obligor present pay or fulfil whatever penalty or obligations attach to him, or if he pays the penalty or fulfils the obligation with his permission, he will have a right

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<sup>25</sup> It may be argued that a surety must fulfil its undertaking in addition to incurring the obligation which is proved to be incumbent on the obligor.

of recourse against the obligor and may recover from him whatever he has paid. However, if neither was with the consent of the obligor, he will have no right of recourse. *Kifala* can be used for risk hedging purposes especially for mitigating the risk of transacting with foreign investors and also the enforcement of foreign judgements or arbitration awards given in international tribunals.

*Takaful* (mutual surety) is created where members of a community who are exposed to a common risk agree to cooperate among themselves for their common good by way of pooling their contributions (subscriptions) in a fund scheme to share and compensate the losses incurred by any of its members collectively. *Takaful* (mutual *kifala*) is a form of Islamic mutual or cooperative insurance the legitimacy of which is based on the *Sharia* concepts of *ta'awun* (mutual help) and *tabarru'* (voluntary contribution) in which the risk is shared collectively by a group of participants voluntarily (i.e., the group members and participants agree to jointly assure one another against loss or damage to any of them as defined in their agreement). Hence, *takaful* provides mutual protection of properties and assets and grants joint risk-sharing in the event of a loss by one of its members. The essential characteristic of *takaful* is akin to mutual insurance in that members are the insurers and also the insured at the same time. The purpose of *takaful* is not to take advantage and benefit at the cost of others. It is basically established for risk hedging and risk sharing purposes.



### 7.2.5 Compromise (*Sulh*)

*Sulh*<sup>26</sup> is a contract made for the purpose of compromise and conciliation, whether it is aimed at settling an existing dispute (e.g., a dispute as to the amount of receivable debts), or to avoid a possible future dispute. *Sulh* on a matter may be in return for a consideration called a “settlement fee”<sup>27</sup> or without any consideration at all. *Sulh* is valid on any matter, except where it relates to an unlawful matter. For example, *sulh* on a right which is an untransferrable right (e.g., the disposal or sale of the corpus of a *waqf* property) is not valid. Also, for instance, if *sulh* on a property or a property right removes it from the reach of creditors, it would not be a valid *sulh*. If, after *sulh*, it becomes known that the subject of *sulh* did not exist at all (i.e., if there has been no valid cause for settlement or compromise), the *sulh* is void. Also, if a mistake occurs in the identity of a party to a *sulh* transaction (albeit in circumstances where the identity of the party is an essential element of the *sulh*) or if there is a mistake in the subject matter of *sulh* (albeit in circumstances where that matter is considered to be an essential characteristic), the *sulh* would be void. A *sulh* which is made in place of a transaction, although it provides the exact same result as the transaction which it replaces,<sup>28</sup> will not be governed by the special rules and conditions of that transaction. Therefore, for example, if the subject of *sulh* is to give an object in return for some consideration, its results will actually be the same result as a sale transaction (*bay*), but the special rules and conditions appertaining to a sale contract will not apply here. However, it seems to be legitimate and valid from the viewpoint of *Sharia*, although the reason and purpose of *sulh* in such circumstances has to be in line

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<sup>26</sup> For more detail on *sulh* see Nasser Katouzian ‘Qanun Madani dar Nazm Huquq Kununi-ye Iran’ (Tehran: Mizan publication, 18<sup>th</sup> Edition, 1387 Solar Hijri Calendar) pp. 470-476, articles 752-770.

<sup>27</sup> *mal al-sulh* or *wajh al-musalaha*

<sup>28</sup> For example, a *sulh* may be made in place of a *tabdil ta’ahhud* (novation-like concept) or *tahatur/muqassa* (set-off-like notion). *Tabdil ta’ahhud* and *muqassa* are also types of risk hedging tools (in addition to being tools for the purpose of satisfying debt obligations).

with its underlying philosophy - for conciliation and the avoidance of any potential future dispute. Otherwise of course, there would be no reason to disapply the special rules and conditions of the substituted transaction in the first place. A *sulh* which is aimed at settling a dispute or is based on clemency or leniency would be binding on the parties, and neither of them can cancel it even if there is a claim of gross loss. The exception here is if there is a breach of an essential condition of the *sulh*, or when an option of cancellation of *sulh* is incorporated in a *sulh* transaction. A *sulh* can be used for different purposes especially for the purpose of compromise on the amount of contribution, distribution of profits and losses and also for the settlement of disputes.

#### **7.2.6 Conclusion**

*Takaful* is the most popular risk hedging facility in the contemporary Islamic insurance industry. It was introduced as a result of legitimacy concerns of the conventional insurance practices, though it seems there is no compelling reason to prove the illegitimacy of the conventional insurance schemes except over problems linked to their *riba*-bearing investment activities and also the fact that it tries to take advantage of risk rather than reducing it. As per modern insurance policies, the insurer provides protection against specific risks for a certain time period in return for an upfront premium paid by the insured. When the specifically agreed risk occurs the insurer will have to compensate the insured, otherwise the insurer will retain the upfront paid premium. According to *Sharia*, if the underlying objective is legitimate (which it is the case here i.e., provision of security), the parties may make a compromise (*sulh*) in a reasonable manner. If the risks which are to be covered under the insurance contract and also the amount of the premium paid for this purpose is considered reasonable, the contract would be valid on the ground of the *sulh* concept. Therefore, although the conventional insurance has been declared forbidden by the

*Fiqh* Academy of the OIC,<sup>29</sup> mainly due to *gharar*,<sup>30</sup> *maysir*<sup>31</sup> and *riba*<sup>32</sup> concerns, modern insurance schemes can easily be practised under the concept and framework of *sulh* contracts with only some marginal amendments and improvements and none of the mentioned concerns as to the legitimacy of the conventional insurance are strong enough to endanger the legitimacy of the conventional insurance practices.

### 7.3 Applications of Alternative Risk Insurance Facilities

It is said that the two *fatwas* in 1900 and 1901, issued by Muhammad Abduh, legitimised the contemporary Islamic insurance practice for Muslims. In the first insurance arrangement, the relationship between the insurer and the insured was based on a *mudaraba* contract and the second one which was a life insurance scheme was established on the basis of *waqf*.<sup>33</sup> The *takaful* industry, which is the most popular

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<sup>29</sup> This was decided in the 9<sup>th</sup> declaration of the 2<sup>nd</sup> session of the Conference.

<sup>30</sup> *Gharar* is construed as the presence of the element of chance or uncertainty taken by the insurer. However, it may be argued that the uncertainty taken under the insurance contract is reasonable and so, it is legitimate.

<sup>31</sup> *Maysir* is construed as the presence of the element of betting or gambling (zero-sum games). The insured gambles in the following way: he knows that he may lose his upfront paid premium if the specific risk does not occur, however, he knows that if the risk happens he will be compensated with more than the premiums he has paid. This should also not be considered problematic because what is essentially intended by the insured is to be secured against the risk rather than to derive profit at the cost of the insurer. According to Mustafa al-Zarqa, in gambling, what the gambler seeks for is that he tries to defeat his competitors to obtain an advantage at their cost. Indeed, the loss of his fellow gamblers becomes his gain. In contrast, in the insurance contract what is essentially sought by the insured is to be secured against specific future losses. See Mohd Ma'sum Billah 'Applied Takaful and Modern Insurance' (Kuala Lumpur: Sweet and Maxwell Asia, 3<sup>rd</sup> edition, 2007) pp. 74-77.

<sup>32</sup> The concern is that the modern insurance companies invest the pooled premium amounts in interest-bearing instruments or other illegitimate ways. However, I would again argue that this is not an inherent problem of the conventional insurance and this concern may easily be addressed if the insurance company avoids investing the pooled contribution amounts in interest-based or other illegitimate activities.

<sup>33</sup> See Mohd Ma'sum Billah 'Applied Takaful and Modern Insurance' (Kuala Lumpur: Sweet and Maxwell Asia, 3<sup>rd</sup> edition, 2007) p. 10.

contemporary Islamic insurance practice, has experienced different models in its operation: *mudaraba* model, *wakala* model, a hybrid *wakala* and *mudaraba* model, and the hybrid *waqf* and *mudaraba* model.

### 7.3.1 Entrepreneurship (*Mudaraba*) Model

*Mudaraba* model, albeit, with some variants, was the earlier legal basis of *takaful* schemes established in the 1980s.<sup>34</sup> According to *mudaraba* (indeed the multiple *mudaraba*) model: a) the people who face the same risk form a group (e.g., in a form of *musharaka*/partnership) and each member of the group contributes some amount of money (underwriting) on the basis of donations or *tabarru*; b) the contributions (also called underwritings or subscriptions) are pooled in a fund and entrusted to an operator called a *mudarib*/entrepreneur on the basis of a *mudaraba* contract; c) all the risks belong to the partnership and the losses are covered from the pooled funds provided by the participants (i.e., the members of the group). The *mudarib* (the operator of *takaful*) is fully indemnified against any risk and loss. In case of any deficit, the participants (or, some may argue the *mudarib*) are required to provide *qard hasana* (i.e., interest-free loans) to cover the shortage; d) the underwriting surplus (profits) is shared between the group as a whole (participants) and the *takaful* operator (*mudarib*) at a pre-agreed ratio; e) this model allows the *takaful* operator

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<sup>34</sup> This was in 1979, when the first Islamic Insurance Company (Ltd) was formed in Sudan. Following the success of this insurance company, other Islamic insurance companies (*takaful* companies) were established in Saudi Arabia, Luxembourg, Bahrain (and many others) in 1979, 1983, and 1983 respectively. For more about the success rate of the *takaful* companies and also the growth of the total premium contributions attracted by the *takaful* companies see Angelo M. Venardos 'Islamic Banking and Finance in South-East Asia' (Singapore: Scientific Press, 2005) pp. 82-83; also Task Force on Islamic Finance and Global Financial Stability 'Islamic Finance and Global Financial Stability' (Kuala Lumpur/Jeddah: IFSB/IDB/IRTI, 2010) p. 32; and Syed Othman Alhabshi and Shaikh Hamzah Shaikh Abdul Razak 'Takaful: Concept, History, Development and Future Challenges of its Industry' (Islam and Civilisational Renewal, vol. 1, no. 2, December 2009) pp. 276-291.

(*mudarib*) to enjoy from the underwriting results from operations and also the favourable performance returns on the invested contributions.

There are a number of *Sharia* concerns which may be raised regarding the above *mudaraba* model.<sup>35</sup> The relationship among the participants in *takaful* is that of *tabarru'* or *ta'awun* (i.e., mutual assistance) but not *musharaka* (i.e., business partnership). Consequently, a profit-sharing standard cannot be applied in a *takaful* arrangement. In other words, contributory donations made by the participants are for the purpose of compensation for specific losses and they cannot be used as *mudaraba* capital at the same time. Under the *mudaraba* contract, the purpose is to generate profits and distribute them between the *rab al-maal* (capital provider) and *mudarib* (entrepreneur). Profit is not the same as surplus (excess of contributions over claims, reserves and expenses). In the insurance (*takaful*) context no profit has to be generated by definition. In other words, *takaful* is used for mutual assistance and hedging purposes but not for the purpose of making profit. The provision of sharing in the underwriting surplus or the profits generated by the *mudaraba* is, in and of itself, something which makes this scheme similar to a commercial business venture but not a mutual contract for mutual assistance and protection. The requirement to provide *qard hasana* (in case of a deficit) in a *mudaraba* contract (whether by *mudarib* or *rab al-maal*) is by definition contrary to the concept of *mudaraba*, which is a profit-sharing contract. Furthermore, notably, a *mudarib* (entrepreneur) cannot be a guarantor in respect of the *mudaraba* capital.

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<sup>35</sup> For a similar discussion see Muhammad Imran Usmani 'Issues in Takaful' (SECP Takaful Conference, March 14, 2007)

### 7.3.2 Agency (*Wakala*) Model

A *wakala* model is another proposed model, which is the most popular and widely used scheme in the most recent Islamic insurance practices.<sup>36</sup> This is largely because of the fact that the *Sharia* Committee of the Islamic Development Bank does not allow the *takaful* manager/operator to share in the underwriting surplus of the *takaful*. In other words, it is said that the *takaful* operator only has to be compensated in the form of service fees.<sup>37</sup> As per this model, the participants who face a common danger contribute to a jointly established fund out of which the losses incurred by any member of the fund have to be compensated. The participants of the scheme appoint an operator to manage the required operations of the scheme (*takaful*). This appointment is based on the *wakala* (agency) concept in the *Sharia*. The operator acts as a custodian and agent of the participants and does not bear any risk or liability for any deficit of the fund. The *takaful* operator (*wakil*) earns a fee in return for the provision of his administrative management services. This fee is often an upfront pre-agreed deductible fee<sup>38</sup> i.e., a certain percentage of the total contributions made to the insurance scheme (*takaful* fund). As for the deficit, a *wakil* (agent) does not share any surplus of the *takaful* fund, and as for liability for any deficit which is borne by the fund, any underwriting surplus is retained by the fund which belongs exclusively to its

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<sup>36</sup> See Syed Othman Alhabshi and Shaikh Hamzah Shaikh Abdul Razak 'Takaful: Concept, History, Development and Future Challenges of Its Industry' (Islam and Civilisational Renewal, vol. 1, no. 2 December 2009) pp. 276-291.

<sup>37</sup> See Islamic Financial Services Board 'Exposure Draft, Guiding Principles on Governance for Islamic Insurance (Takaful) Operations' (Kuala Lumpur: IFSB, December 2008) p.3, fn. 7.

<sup>38</sup> As per Islamic Financial Services Board (IFSB), the operator fee (*haq al-wakala*) must be an expressly pre-agreed fee at the time of his appointment contract. All the costs and expenses related to the management and distributions will have to be paid from the source of this fee and the operator is not entitled to claim for any extra fees to cover these types of costs and expenses. See Islamic Financial Services Board 'Exposure Draft, Guiding Principles on Governance for Islamic Insurance (Takaful) Operations' (Kuala Lumpur: IFSB, December 2008) p.4. However, as far as the reimbursement of these types of costs and expenses is concerned, it seems it can be agreed otherwise.

participants. There is no *Sharia* concern in the *wakala* model with the above characteristics.

### **7.3.3 The Combination of Agency (*Wakala*) and Entrepreneurship (*Mudaraba*) Model**

The combination of *wakala* and *mudaraba* is another innovative model. As per this model, the operator of *takaful* plays two different roles: an agency role (*wakil*) and also an entrepreneurship role (*mudarib*). The operator of *takaful* earns a fixed service fee for his agency role as a *wakil* and also shares in the underwriting surplus as well as the proceeds arising out of the investment of the *takaful* fund as a *mudarib*.

A major *Sharia* concern in the above model is hybridisation. The hybridisation, in and of itself, is not problematic from the viewpoint of *Sharia*, but it is a problem here. Hybridisation is valid if the combination of two or more concepts does not lead to a contradictory result. The inherent characteristic of a *mudarib* (entrepreneur) is to share in the loss and profit of the entrepreneurship scheme. In contrast, the salient feature of a *wakil* (agent) is to receive only a fixed fee in return for the provision of certain services to its principal. Consequently, unlike a *mudarib*, a *wakil* is neither liable for the loss of funds entrusted to him to carry out the required transactions nor liable toward the third parties with whom he acted on behalf of the principal. In cases where the compensation of the *takaful* operator is linked to the outcome of the business, he is no longer a *wakil* but a *mudarib*. Since the purpose of establishment of the *takaful* is not to carry out investment activities but only for the mutual assistance of its participants, the proper solution is that the *takaful* operator be treated as the *wakil* of the *ta'awun* (i.e., *takaful*) scheme to which the participants contribute voluntarily on the basis of *tabarru'*. It should be noted that, as per the Islamic Financial Services

Board (IFSB),<sup>39</sup> in addition to his fixed service fee, a *wakil* is permitted to receive part of his remuneration on the basis of his performance i.e., to share in the underwriting surplus. The IFSB's argument for this claim is that the participants of the *takaful* do not need the underwriting surplus. However, this argument is not strong enough and this practice should be disallowed for the conflict of interests of the participants and the *wakil*. It is highly likely that this practice will deviate the *takaful* from its main purpose. The *wakil* will try, as much as he can, to avoid compensating the incurred losses of the participants in order to increase his share in the underwriting surplus.

#### **7.3.4 The Combination of Trust (*Waqf*) and Entrepreneurship (*Mudaraba*) Model**

The combined *waqf* and *mudaraba* model is another one that has been introduced for *takaful* purposes.<sup>40</sup> As per this model, in order to eliminate the elements of *maysir* and *qimar*, the concepts of *waqf* and *tabarru* are integrated. On this basis, participants relinquish as *tabarru* and *waqf* a certain amount of contributions to the *takaful* scheme called a *waqf* fund, and the contributions of the

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<sup>39</sup> See Islamic Financial Services Board 'Exposure Draft, Guiding Principles on Governance for Islamic Insurance (Takaful) Operations' (Kuala Lumpur: IFSB, December 2008) p. 4.

<sup>40</sup> This is to some extent similar to the structure of the Takaful Company of Malaysia. For more in this regard see Nik Ramlah Mahmood 'Insurance Law in Malaysia' (Butterworths: Utopia Press, 1992) pp. 245-246. Participants contribute to two different accounts: the Participants' Account (which is in fact a savings and investment account) and the Participants' Special Account (which is conceived in the spirit of *tabarru* and is used to assist the fellow participants in times of hardship). The latter account is very similar to what is intended by the establishment of a cash *waqf*. The funds in the latter account are invested but unlike the profits of the former account which are shared between the *takaful* company and the participants, the profits generated from the latter account are ploughed back into the account to enhance its capital amount.



*waqf* fund paid as *tabarru* by the participants are invested by the *takaful* company<sup>41</sup> in *Sharia*-compliant modes of investment and trade. The following are the basic features of the *waqf* and *mudaraba* model: a) a *waqf* fund is established by a *takaful* company (this may be a conventional insurance company) to pool the voluntarily contributed amounts of the (often Muslim) participants; b) these funds are invested by the *takaful* company; c) the *waqf* fund including any generated profits out of the *waqf* investments are used to compensate its members in the event of losses according to the rules of the *waqf* fund for distribution, extend benefits to its members according to the *waqf* deed, and also donate to charities approved by the *Sharia* Supervisory Board; d) the *waqf* fund is considered a separate legal entity and acts as per its establishment terms for investments, compensation and dealing with the surplus amounts of the fund; e) the *waqf* fund is deemed the owner of all contributions made to it by the subscribers; f) the *takaful* company maintains a portion of surplus amounts as reserve to mitigate future losses, a portion distributed among the participants to differentiate it from the conventional insurance schemes, and also a portion of surplus utilised for the charitable purposes every year; g) in cases where the *waqf* fund is liquidated, the outstanding balance, after paying all dues and payables, is utilised for charitable purposes; h) the *takaful* company, while managing the *waqf* fund, plays two different roles simultaneously: as operator or manager of the *waqf* fund (i.e., *mutawalli* of the *waqf* fund) and also as a *mudarib* in dealing with the investments of the *waqf* fund; i) as operator or manager, the *takaful* company performs all functions necessary for the operations of the *waqf* fund against a certain fixed operator (*mutawalli*) fee to be deducted from the contributions of the participants; j) as *mudarib* of the fund, the

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<sup>41</sup> As an already established company, this is an entity like the Takaful Company of Malaysia just explained above. This Takaful Company, which may in fact be a conventional insurance company, sets up a *waqf* fund (as one of its arms or windows in parallel to its other conventional activities) in order to attract Muslim participants.

*takaful* company manages the investment of the excess funds of the *waqf* in a *Sharia*-compliant manner and shares in the profits of the *waqf* fund's investments at a fixed pre-agreed ratio.<sup>42</sup>

A very serious *Sharia* concern over the above model which makes it to a large degree illegitimate is that the establishment of a *waqf* fund for the benefit of *waqifs* (participants/contributors) themselves, in such a way that they make themselves the sole beneficiaries or some of the beneficiaries or provide for the payment of their debts or other obligations out of the proceeds of the *waqf* estate, is considered null and void. It may be argued that, according to *Sharia*, in the case of a *waqf* for the public use, if a *waqif* becomes one of the beneficiaries of a *waqf* estate he is permitted to benefit. The answer to this depends on whether the above said *waqf* fund is actually for the public use or the benefit of *waqifs* themselves. It is less likely that the above said *waqf* fund is considered to be used for public good. It seems, however, this model may be modified to make it a legitimate model from the perspective of *Sharia*. This may happen through the combination of *waqf* with *sulh*. For this purpose, every single participant of the scheme will have to make his contribution (albeit, in the form of non-monetary and non-consumable assets) to the *waqf* fund for the benefit of other participants (not including himself). Then, the beneficiaries of the *waqf*, who are indeed the participants themselves, may compromise as to the condition and amount of compensation each may receive from the *waqf*. The hybridisation is another concern in the mentioned *waqf* and *mudaraba* model. As with the illegitimacy of the combination of *wakala* and *mudaraba*, the hybridisation of *waqf* with *mudaraba* leads to a contradictory result as well. While the *mutawalli* (the manager of *waqf*) does not share in the profits and deficits of the *waqf* (and he earns only his service fee like an

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<sup>42</sup> For a similar explanation see Muhammad Imran Usmani 'Issues in Takaful', SECP Takaful Conference, March 14, 2007).

agent/*wakil*), a *mudarib* (the entrepreneur) does share in the profits and losses of the investments. Another major concern is the use of the funds of the *waqf*. According to *Sharia*, *waqf* assets may not be channelled into investment purposes.

### 7.3.5 Conclusion

Considering the above models, the proper solution for the *takaful* is the model combining *sulh* (compromise) with *wakala* (agency). In return for the provision of security, *takaful* participants make certain contributions to a *ta'awun* scheme (cooperative scheme) on the basis of a *sulh* arrangement (compromise). As said earlier, according to *Sharia*, it is legitimate to make a compromise if the subject matter of the compromise (*sulh*) is a beneficial act. This is exactly the case here. The *takaful* scheme participants will collectively appoint a *wakil*/agent (in return for payment of a certain service fee) to manage the necessary operations of the *takaful* scheme.

## **Chapter Eight:**

# **The Third Tier of the Model: The Superstructure and Political Regime of the Model**

## 8.1 The Economic Authority

Under the “separation of powers” governance, which is ascribed to French Enlightenment political philosopher Baron de Montesquieu,<sup>1</sup> the political power of a state is divided into three branches (a legislature, an executive, and a judiciary) each with separate and independent powers and scope of responsibility. In modern sense, the management of the economy is with the executive branch subject to its control and supervision by the legislature. This research project, however, suggests a new approach in which the management of the economy (i.e., the distribution of natural wealth resources and the control of the circulation of subordinate wealth) is taken away from the state (executive power) and it is assigned to and controlled by a new independent authority called the “Economic Authority”. The Economic Authority consists of a “House of Wealth” and a “House of Market Control”, the first to administer the system of distribution of primary wealth and the second to control the proper circulation of subordinate wealth.

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<sup>1</sup> See ‘Baron de Montesquieu, Charles-Louis de Secondat’ (Stanford Encyclopedia of Philosophy), Available at [Plato.stanford.edu](http://Plato.stanford.edu), Retrieved 14 April 2013.

## 8.2 The House of Wealth

An authority, the House of Wealth<sup>2</sup> as a Trustee (*mutawalli*) of the public (and as such of the natural wealth resources) is set up to administer these resources on behalf of the public.<sup>3</sup> On this basis, it is in charge of securing basic essential needs of the people such as the provision of dwelling house, education and healthcare facilities and the supply of basic infrastructure utilities. The House of Wealth, as the representative of the public, may levy tax (*kharaj*) in return for the utilisation of natural wealth resources and the collected *kharaj* has to be spent on the needs and in the best interests of the public. The House of Wealth may consist of different departments (*bayts*) for the administration of different types of natural resources such the House of Land, House of Minerals, and House of Water Bodies. The House of Wealth is managed by a Board of Trustees (*mutawallis*)<sup>4</sup> and they are elected and also supervised directly by members of the public themselves or indirectly through their representatives. The

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<sup>2</sup> The closest Islamic terminology to the House of Wealth is bayt al-maal. A religious authority that can support the founding philosophy of this institution is the Quran (4:58) “deliver trusts to those worthy of them; and when you judge [distribute the wealth] between people, to judge [distribute] with justice”. Undoubtedly, universally, political governments have proved that they are not worthy of managing the distribution of natural wealth resources. That is why it seems there is an absolute need for a separate body responsible for the proper management of the natural wealth resources. These resources have to be utilised for the best interests of their true owners (the public as a whole) rather than the political ambitions of the governments and their leaders. Philosophically, any natural wealth in any part of the universe has to be enjoyed by any human being in any part of the world. Due to practical considerations it can be started domestically, then regionally and eventually rolled out globally.

<sup>3</sup> This is the philosophy of the House of Wealth vis-à-vis the Treasury of State, in the modern sense. For a somewhat different view with regard to the distribution of primary wealth see the Constitution of Iran article 45 “public wealth and property such as uncultivated or abandoned lands, mineral deposits, seas, lakes, rivers and other natural public waters, mountains, valleys, jungles, marshlands, natural forests, unenclosed pastureland, legacies without heirs, property of unknown-owners, and public properties that were recovered from usurpers, shall be at the disposal of the Islamic government for it to utilise them in accordance with the public interests.” The research’s approach is that all these properties belong to the public but not the government and they have to be distributed among the members of the public according to their reasonable needs on the basis of equity.

<sup>4</sup> This is similar to the role of a board of trustees in common law trusts and mutawalli in Islamic waqf.

House of Wealth will have to distribute the proceeds of the natural wealth resources according to the reasonable needs<sup>5</sup> of every member of the public and for some of these resources the distribution can be done according to the contribution of each person involved in their exploitation. The distribution policy should be detailed in a deed and the House of Wealth should administer the natural wealth according to the terms of the distribution deed. The House of Wealth has a custody interest but not a possession one with regard to the wealth under its administration. The House of Wealth has no authority to dispose and surrender the ownership of the corpus (origin) of the natural wealth nor can it use the natural wealth resources for some business and investment purposes. It is only the proceeds that are generated either in the form of profit or rent that will be distributed among the beneficiaries, which are the members of the public.<sup>6</sup>

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<sup>5</sup> Some may argue that it has to be distributed equally, otherwise it is unjust. However, as per the research theory, justice means balance and balance requires distribution of natural wealth resources on an equitable basis i.e., according to the reasonable and legitimate needs of people.

<sup>6</sup> The House of Wealth is a new institution that has to be established according to the research model and it is introduced here in very general terms. It is a new subject altogether and is an issue for later research in great detail.

### 8.3 The House of Market Control (“HMC”)

Another authority, the House of Market Control (HMC) should be set up to regulate and monitor the creation, use, accumulation and disposal of subordinate wealth, without involving itself with economic, business and financial activities.<sup>7</sup> The need to set up such an authority is well established in the *Sharia* and, unquestionably, in the modern world. According to *Sharia*, people should circulate whatever is surplus to their reasonable needs and not hoard<sup>8</sup> their savings. The necessary effect of this

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<sup>7</sup> This is somewhat similar to an Islamic authority called a muhtasib. Muhtasib was an officer to inspect and assure that all market participants were performing their tasks correctly and morally, settling market-related disputes in marketplaces, and ensuring customers were not cheated in the market. The Muhtasib had the authority to annul market rules and orders which were unjust on religious reasons. It can be said that the nearest western concept to Muhtasib is Ombudsman. See Roberta Jamieson ‘The Ombudsman: Learning from other Cultures’ (Ottawa Law Review, Vol. 25, Issue 3, 1993, pp. 629-640) pp. 635-636. Some scholars may argue that why Muhtasib, as a historically used and developed authentic Islamic institution, is not used instead of “The House of Market Control”. This is mainly because the scope of power of “HMC” is considered to be much broader than Muhtasib. The HMC is indeed supposed to be an exclusive market policy-maker, market regulator and market supervisor. Furthermore, the head or the managing members of HMC have to be selected by the members of the public whether directly or indirectly, unlike Muhtasib who is appointed by the ruler of the state.

<sup>8</sup> As per the Quran (59:7) “so that it may not merely circulate between the rich among you”. Also as per the Quran (9: 34&35): “and there are those who amass gold and silver ... announce to them the severity of punishment that they should wait for... on a Day when they shall be heated up in the Fire of Hell ... (and they shall be told) this is the treasure which you hoarded for yourselves. Taste, then, the punishment for what you have hoarded”.



order is to inject savings<sup>9</sup> into the circular flow of income generation in the economy in order to prevent and avoid the consequences of the concentration of wealth in the hands of a few rich people. In other words, the philosophy of the establishment of the HMC is to secure the proper circulation of wealth in the society in order to avoid the negative impacts of the concentration of wealth in the hands of a few people or groups. It is highly likely that the concentration of wealth results in corruption in the political system and also creates an unhealthy economy, simply because the wealthy will encourage the political system to run in such a way that mainly serves their interests and wishes while disregarding the main concerns of the society as a whole, namely, social welfare, prosperity and social justice. It is for these reasons that, for instance, deposit accounts as they are practised in modern banking should be avoided because they are to a very large extent controlled by multinational corporations and a

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<sup>9</sup> In practice, modern Islamic banks take the savings of the surplus-capital holders in deposit and apply them in the liability side of their balance sheet in one of these forms: a) deposit accounts on the basis of wadi'a or amana with no interest given to the depositors (the account is only for the safekeeping of the deposits); b) investment accounts on the basis of mudaraba in which the profits generated from the investments will have to be shared between the bank and depositor/investor according to a pre-agreed ratio (however, in practice the return to the depositors/investors is benchmarked to the prevalent conventional rate of interest and it does not reflect the true contingent profit or loss originating from the investments); c) commodity murabaha or tawarrugs whereby the Islamic bank pays a fixed return to the capital holder (in practice, tawarrug has been invented to replicate the modern lending mechanism under the name of murabaha i.e., the purpose is not a true murabaha/sale according to Sharia but rather only the circumvention of a riba prohibition). Of these three forms, it is only the first one that is acceptable (to be practised by the banks "PDIs") according to Sharia but neither the second one (as it is in fact practised) nor the third one.

few so-called mega banks operating worldwide.<sup>10</sup> Also, it is fair to say that the greater the concentration of wealth, the greater the probability of systemic risk. This systemic problem should be addressed by the HMC. The mission of the HMC is to ensure that the ultimate objective of the system, social justice<sup>11</sup> prevails.<sup>12</sup> In an economic and financial context, what is meant by social justice is a “justly balanced economic and financial system”. As per the *Quran*<sup>13</sup>, in the first place, people are free to make money as much as they can with no upper limit, however they should redistribute their accumulated wealth among themselves by way of using legitimate transactions and voluntary means. If they fail to achieve this, then the society as a whole (the HMC) has

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<sup>10</sup> Referring to the Sharia concepts of hifz al-maal (protection of property), hifz al-nafs (protection of self), and hifz al-nasl (protection of the future generations) which are considered three essentials aspects in Sharia (i.e., Maqasid al-Sharia), some Islamic scholars argue for the necessity as well as legitimacy of deposit-guarantee/protection either by the state (such as Savings Accounts’ Insurance Fund established as a state financial institution in 1933 in Turkey) or by a national deposit insurance (takaful) scheme. They further argue for the payment of an annual inflation premium by Islamic banks to the deposit accounts. See Monzer Kahf ‘The Use of Assets, Ijara Bonds for Bridging the Budget Gap’ (Islamic Economic Studies, vol.4, no. 2, 1997) p.75. However, since annual inflation premiums as well as the guaranteed-deposit-protection plan by the government (i.e., the financial system as a whole) will encourage deposit accounts and also more savings by the people, it is clearly in contradiction with the discouragement (not to say the prohibition) of the deposit/savings by the Sharia. There is no legitimate reason to guarantee the bank deposit accounts from the public property sources e.g., guaranteed by the taxpayers (although the Task Force on Islamic Finance in their meeting on April 2010 considers the deposit insurance as a necessary part of the financial safety net). It is unfair that the deposit accounts are guaranteed by the central bank or any other public agency (the HMC) simply because every single member of the public does not have a savings account and if any, they do not have the savings in equal amounts. Another Sharia impediment in this respect is that deposits that are taken under the concept of wadi’a cannot be guaranteed, otherwise it will not in principle be a wadi’a contract at all. In addition to deposit insurance plans in modern banking, some may argue that the financial system has to be responsive as to the investors’ demand for the protection of their investment accounts. However, this is not only problematic due to the practical problems in the evaluation of the fair value and also riskiness of the underlying assets pertaining to these sorts of accounts but also the banks (PDIs), by definition, cannot engage in real investment activities.

<sup>11</sup> Some scholars argue that “proto-quasi-Ottoman socialism” emerged on this perspective during the Ottoman Empire. See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 21.

<sup>12</sup> See Abbas Mirakhor and Idris Samawi Hamid ‘Islam and Development, The Institutional Framework’ (Global Scholarly Publications, 2009).

<sup>13</sup> The Quran (2:143 and 59:7)

to interfere to cause the proper circulation of wealth in the economy and also, if necessary, redistribute the wealth using the obligatory means, subject to protection of the property rights of the people (in *Sharia* it is called “*hifz al-maal*” which is one of “*Maqasid al-Sharia*” and one of the primary duties of the HMC). As can be seen, the approach taken by the *Quran* is a middle-way. This is somewhat in contrast to the view of some Islamic scholars who argue that the members of the society themselves, based on their personal and religious beliefs, should ensure that social justice is achieved.

The HMC is run by a board with broad policymaking and regulatory powers over the entire economic, business, and financial system (except the distribution of natural wealth resources) including for-profit, not-for-profit, philanthropic, microbusiness, intermediary and risk hedging activities, and also with the power to issue rules with the force of rules and policies.<sup>14</sup> The members of the board will have to be independent experts appointed by the representatives of the public or, it may be said, that they will be elected directly by the members of the public similar to the board of the House of Wealth. The HMC board is granted all regulatory, executive, and judiciary powers required to ensure the proper running of the whole system. The HMC is

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<sup>14</sup> HMC will have to take “functional” approach in its rulemaking role. “Functional” approach is an alternative to an “entity” approach. Rather than introducing regulations based on the type of institution, rules and regulations are introduced and enforced according to the “function” performed (no matter which institution performs that specific function). For more, eg, see Jane E. Willis ‘Banks and Mutual Funds: A Functional Approach to Reform’ (Columbia Business Law Review, Vol. Issue 1, 1995, pp. 221-280) p. 228.

essentially responsible for protecting, fostering, and advancing the proper creation and circulation of wealth in the entire economic, business, and financial system.<sup>15</sup>

Market participants have to be free to trade their assets and property rights in exchange markets with fair prices,<sup>16</sup> fair competition and equal access to markets. The price of the *sukuk* (securities) traded in stock (*sukuk*) exchange markets should reflect the real value of the underlying assets and not speculative prices.<sup>17</sup> The House of Market Control should not interfere in the market operations except in extraordinary circumstances, e.g., when distortions occur in the market due to *ihtikar*<sup>18</sup> (hoarding), *de facto* monopolies, abusive conduct, or information asymmetries. The general policy of the House of Market Control should be that there must be no imposition of tax on

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<sup>15</sup> I would argue that the whole system of the circulation of secondary/subordinate wealth has to be controlled by the same authority (i.e., the House of Market Control).

The recent financial crisis proved that problems in capital markets may have a huge impact on financial institutions, and vice-versa. The freezing of the securitization markets in the West (especially in the US) resulted in declines in the values of banks' holdings of ABS (asset-backed securities), which in turn put at risk the solvency of many banks and the banking system as a whole. The most developed financial regulatory structures e.g., in the US were largely based on the premise, once true, that banking, securities and insurance were separate functions with separate tools, and thus could be treated separately for regulatory concerns (though financial innovation has blurred these lines for the following reasons: a) credit default swaps (which are one of the major types of sophisticated securities) are in fact insurance against default; b) money market funds mimic many of the features of bank deposits; c) a range of debt securities have significantly reduced the importance of banks as the primary lenders to businesses; d) most notably, securitization became the main source of capital for bank lending until the recent financial crisis shut it down).

<sup>16</sup> According to some Islamic scholars, like Ibn Taymiyya, what is meant by "fair price" is the prevalent price among the majority of merchants. It is, furthermore, argued that the interference of the state (the House of Market Control) in the price fixing mechanism (i.e., *narkh* or *thaman*) is *mazlama* i.e., an injustice, arbitrariness and usurpation of the property of others. See Yassine Essid 'A Critique of Islamic Economic Thought (Leiden: Brill, 1995) pp. 151, 156, 159. See also Muhammad Akram Khan 'Economic Teachings of Profit Muhammad' (Islamabad: Institute of Policy Studies, 1989) p. 126.

<sup>17</sup> For a similar approach see Mahmmod Mohamed Sanusi 'Critical Issues on Islamic Banking, Finance and Takaful' (Kuala Lumpur, INCEIF, 2010) p. 188.

<sup>18</sup> In case of market distortions and hoarding, the House of Market Control may interfere and under some circumstances confiscate the hoarded goods and sell them in the market at a fair price. The sold revenues minus the profits generated from the sales will be returned to the hoarder and the earned profits are distributed to the affected consumers or the poor as alms.

market transactions and no restrictions on international transactions.<sup>19</sup> There should be no barriers to enter and exit the market and also no barriers to move freely from one market to another.

The enforcement of market rules and transactions has to be given full effect by the House of Market Control (or *muhtasib*<sup>20</sup> according to Islamic finance) in order to ensure balance in the market and minimise the risk of default and uncertainty among market participants. Some important responsibilities of the House of Market Control are: to check fair competition of businesses and fair trading, correct weights and measures<sup>21</sup>, monitor pricing mechanisms, audit illegal transactions, prevent market fraud and abuses and hoarding of necessities and also to teach the market participants to regulate themselves according to the market rules and policies.<sup>22</sup> As far as business associations and business collective schemes are concerned, the most important function of the House of Market Control (*muhtasib*) is to check the proper functioning

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<sup>19</sup> See Huner Sencan 'Is Hayatinda Islam Insani (Homo-Islamicus)' (Istanbul: MUSIAD, 1994) p. 6.

<sup>20</sup> It is indeed a market inspector. Muhtasib (similar to "Ombudsman" in modern market sense) is assigned with much less power than that of HMC in the suggested new model.

<sup>21</sup> As per the Quran (55:9): "so establish weight with justice and fall not short in balance".

<sup>22</sup> For more details on the functions of muhtasibs see Z. Iqbal and M.K. Lewis 'An Islamic Perspective on Governance' (Edward Elgar, 2009) pp. 261-265. See also A. R. Abdul Rahman 'Issues in Corporate Accountability and Governance: An Islamic Perspective' (American Journal of Islamic Social Sciences, vol. 15, 1998) p. 55.

of business forms and financial institutions in terms of their having good corporate governance and following the objectives of social responsibility.<sup>23</sup>

The intervention and functioning of the HMC will be on the basis of clearly defined policies and rules.<sup>24</sup> Some major policies and rules in this regard are given below.

### **8.3.1 Equitable Distribution Prevails over Efficiency Rule**

The “equitable distribution prevails over efficiency”<sup>25</sup> rule states that, in case there is any conflict between distribution and efficiency rules, the distribution policy will override the efficiency theory. This is because the social balance (i.e., the fair distribution of wealth among all human beings in the society) is given priority over the concentration and maximization of material wealth, which is controlled by a small

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<sup>23</sup> The proper management and accountability of business associations are of concern to the stakeholders who have an interest in the business associations, as well as to the wider community and the public. Different jurisdictions have taken different approaches in the legal and regulatory frameworks for corporate governance and social responsibility of business associations. For some interesting discussions about corporate governance in the Islamic context see A.R. Abdul Rahman ‘Issues in Corporate Accountability and Governance: An Islamic Perspective’ (American Journal of Islamic Social Sciences, vol. 15, 1998) p. 55. Also, M. U. Chapra and H. Ahmed ‘Corporate Governance in Islamic Financial Institutions’ (Islamic Development Bank, Islamic Research and Training Institute, 2002) p. 26. They argue that, from an Islamic perspective, there is basically no difference between corporate governance and corporate social responsibility, unlike what is understood under the shareholder primacy model in Capitalism. They believe that, from an Islamic viewpoint, business ethics (akhlaq) is of vital importance.

<sup>24</sup> From the perspective of Sharia, it may be argued that the entire rules and policies in this regard must be in conformity with the Objectives of Sharia known as Maqasid al-Sharia. However, it may also be argued that the HMC may sometimes take decisions on the basis of social maslaha i.e., for the good of the society.

<sup>25</sup> Efficiency is in itself respected; but as far as it is linked to the concentration of wealth and limited liability shield and other similar notions it is overruled by the equitable distribution rule.

percentage of businessmen and corporations.<sup>26</sup> There is some evidence in *Sharia* that strongly emphasises the importance of the redistribution of wealth either through voluntary instruments or by way of obligatory means. The concentration of wealth, on the other hand, which is basically a prerequisite of efficiency in the economy, is strongly discouraged.

### **8.3.2 Using the Paper/Electronic Currency as a Medium of Payment and Not an Index of Value Measurement**

The invention of money<sup>27</sup> and its position as the only means of transacting and pricing products and commodities has affected the use of barter<sup>28</sup> (*mua'wada*)

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<sup>26</sup> As per Chapra, "the very objective of Sharia is to promote the welfare of the people, which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves the public interest and is desirable." See M. Umer Chapra 'Islam and the Economic Challenge' (Leicester: The Islamic Foundation, 1992) p. 1.

<sup>27</sup> According to Mann, money has a variety of different meanings in different contexts. To provide a legal definition of money, some account of its economic functions has to be reflected in the legal definition. Key definitions that have been provided by economists regarding money are "[money] as a medium of exchange" (see, eg, William Stanley Jevons 'Money and the Mechanism of Exchange' (Kegan Paul, 14<sup>th</sup> edition, 2002) first published in 1875 and also see Graham Bannok and William Manser 'International Dictionary of Finance' (S. Wiley & Sons, 2000) p. 181; "[money] as a measure of value or as a standard for contractual obligations" (see, eg, A. Crockett 'Money, Theory, Policy and Institutions' (Nelson, 2<sup>nd</sup> edition, 1979) p. 6 and also see George Macesich 'Issues in Money and Banking' (Praeger, 2000) chapter 3; "[money] as a source of value or wealth" (see, eg, Eamonn Butler 'Milton Friedman: A Guide to His Economic Thought' (Gower, 1985) p. 67 and also see Mervyn Lewis and Paul D. Mizen 'Monetary Economics' (Oxford University Press, 2000) pp. 10-11; and "[money] as a unit of account" (see, eg, Georg Simmel 'The Philosophy of Money' (Routledge, 2<sup>nd</sup> edition, 1990) chapter 2. According to Lewis and Mizen (p. 4), the focus of economists on each these functions of money has varied at different times but, according to Roberston (see D. H. Roberston 'Money' (London, 1927), it seems that the function of money as a medium of exchange (what is actually argued in the thesis) is today regarded as its key function and characteristic. Considering the abovementioned economic functions of money that have been provided by the economists, Mann adopts a functional approach in formulating the legal definition of money. As per Mann "money is that which serves as a means of exchange- subject to the crucial proviso that its functions must have the formal and mandatory backing of the domestic legal system in the State or area in which it circulates". In other words, a legal definition of money must provide both the economic functions of money and the legal context within which it must be created and implemented. See Charles Proctor 'Mann on the Legal Aspect of Money' (Oxford University Press, 7th edition, 2012) pp. 9-15.

transactions. The invention of money made it possible for the producer of the goods to sell his excess products in return for a specific amount of money and allows him to delay the purchase of the products he desires to some future point. Thus, the emergence of money delinked the direct relationship between production and consumption. The storing of money was much easier than the storage of products and commodities. This development made the hoarding of wealth much easier than in the past.<sup>29</sup> Unlike barter transactions, money paved a new way of creating wealth. A person with money was able to buy the products of others and hoard them in order to influence the price of products in the market. It seems this development in business and finance contributed significantly to the improper distribution of wealth and consequently an imbalance in the social distribution system and made it even more imbalanced throughout the passage of time.<sup>30</sup> Money was gradually treated, in and of itself, as a very desirable asset in the economic life of the people and made it possible for people to compete in the acquisition and the concentration of their wealth in the form of money. To create more money and to increase their existing wealth from the

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<sup>28</sup> Some scholars have defined barter as the “direct exchange of goods and services without any medium of exchange for settling payment”. See Pierre Siklos ‘Barter and Barter Economics (Oxford Encyclopaedia of Economic History)’ (Oxford: Oxford University Press, 2003) p.242. According to Sharia, in barter transactions, the exchange of the same goods in different quantities or quality is considered *riba*. As to the illegitimacy (i.e., *riba*) of the barter of lower quality goods for better ones of the same goods see Malik ‘Book 31 (Business Transactions)’ Hadith 31.12.21; see also Muslim ‘Book 10 (Book of Transactions)’ Hadith 3861. This type of *riba* is called *riba al-mua’wadi* or *riba al-mua’mali*, which is more relevant in commodity markets as well as currency and interest rate exchange markets. The other type of *riba* is called *riba al-qardi*, which is more challenging in modern Islamic banking and finance. As it is well known, historically barter transactions precede lending transactions. Therefore, logically, *riba al-mua’wadi* should have come to light prior to the *riba al-qardi*.

<sup>29</sup> One of the solutions introduced in Islam to prevent the deviation of money from its true function (i.e., using money only as a medium and facility of exchange of goods) and also to avoid the concentration and hoarding of money, has been the imposition of more *zakat*/tax on the cash part of wealth.

<sup>30</sup> However, prior to the invention of money in the business and finance world, it seems the initial improper distribution of natural wealth resources was the starting point of an imbalance in the distribution system.



source of stored currency, a new, third<sup>31</sup> facility was invented. This innovation was a new type of transaction. This transaction was neither the exchange of a commodity with another commodity (i.e., the barter transaction or *mua'wada*) nor the exchange of commodities with some amount of money (i.e., the sale contract or *bay*) but rather it was to transact some amount of money in spot against the same amount of money plus an addition in the future (i.e., interest-bearing lending transactions or *qard rabawi*). The additional amount that is stipulated in the lending transaction is called *riba* in Islam and it is expressly prohibited according to the *Quran*.<sup>32</sup> Regarding the underlying rationale for the prohibition of *riba*, it may be said that the reason is to avoid the problem of exploitation in the economy. Some may argue it is to prevent an imbalance in the distribution of wealth, which is in fact an immediate result of the concentration of wealth and concentration of power in society. It may also be said that the prohibition of *riba* is an immediate implication of the prohibition of hoarding (whether it is *ihtikar* or *kanz*<sup>33</sup>) in *Sharia*. Moreover, some may argue that the prohibition of *riba* needs to be obeyed for religious reasons especially due to *hifz al-din* (protection of religion), which is considered to be one of the essentials of *Maqasid al-Sharia* (objectives of *Sharia*). While all these arguments make sense, there is no consensus among *Sharia* scholars as to the true philosophy of the prohibition of *riba*.

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<sup>31</sup> What is meant by the first facility is "barter" (*mua'wada*) and "sale" (*bay*) is the second one. At the time of its invention, some people thought that the third facility i.e., trading money against money was another type of *bay*. However, the *Quran* warned these people of their misunderstanding and expressly declared that this new facility is not a legitimate *bay* but indeed an illegitimate transaction of *riba*. As per the *Quran* (2:275): "they said that the lending transaction is in fact a true sort of *bay* contract while Allah legitimised *bay* transactions, but prohibited that type of *bay* that includes an excess amount (*riba*) therein".

<sup>32</sup> However, if no addition is stipulated in the lending transaction it will be a legitimate lending transaction known as *qard hasana*.

<sup>33</sup> The hoarding of gold and silver is called *kanz*. Hoarding of any other types of commodities and products is called *ihtikar*.

Today, there are Islamic scholars<sup>34</sup> who advocate the return to the Islamic gold dinar<sup>35</sup> which they claim will not have as many drawbacks as modern paper currency, such as inflation. Some of these scholars also believe that since the Prophet himself used coins, it is then appropriate for Islam-ruling states to replace the modern paper currency and adopt the *sunnah* of the Prophet by the implementation of the coinage system (i.e., gold dinars).<sup>36</sup> On the other hand, there are some scholars who argue for the legitimacy of the use of the modern paper currency. These scholars argue that well-known Islamic jurists Mohammad al-Shaybani, Ibn Taymiyyah, and Ibn Qayyim did not limit the acceptable forms of currency to gold and silver coinage (i.e., gold dinars). Also as per Ibn Hanbal, it is acceptable to adopt as currency anything that is used widely by the public. Furthermore, the most respected contemporary Islamic jurists Taqi Usmani and al-Qaradawi have also adopted the same approach.<sup>37</sup> Some may argue that the de-linking of the currency-gold relationship has been a basic cause of inflation and re-linking all currencies directly to gold and firmly following the specified

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<sup>34</sup> These are known as “dinarists”.

<sup>35</sup> It is the use of coinage, containing gold or silver, rather than paper currency. During the 7<sup>th</sup> and 8<sup>th</sup> centuries, Islam conquered the two great empires of the time, namely the Byzantine and Sassanid territories and confiscated huge amounts of Byzantine gold coins and Sassanid silver coins (known as booty/ghana’eem) hoarded in churches and temples. These coins (a bimetallic system) were then confirmed and used as legal tender in the Islamic world. This substantial amount of treasure increased the aggregate money supply and most likely led to a dominant monetised trade in the economic system. See Andre Wink ‘Al-Hind, The Making of the Indo-Islamic World’ (Leiden: Brill, vol. 1, 1991) p.34. See also Cengiz Kallek ‘Hz. Peygamber (S.A.S) Doneminde Devlet ve Piyasa’ (Istanbul: Bilim ve Sanat Vakfi, 1992) pp. 82-83.

<sup>36</sup> For more see Ahamed Kameel Mydin Meera ‘The Islamic Gold Dinar’ (Pelanduk Publications, Sdn Bhd, 2002) pp. 88-89. The claim is to transform the currencies as they are used today into gold dinars, which were historically practised in the Islamic world as well as the Prophet himself in the early Islamic period. It is believed that the Prophet used Byzantine and Persian coins, and the true Islamic coins came out later. At the time of the Prophet, paper currency had not yet been introduced. See Murat Cizakca ‘Islamic Capitalism and Finance: Origins, Evolution, and the Future’ (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 229.

<sup>37</sup> For detail in this regard see Muhammad Aslam Haneef and Emad Rafiq Barakat “Must Money be Limited to Only Gold and Silver?” (Journal of King Abdulaziz University: Islamic Economics, vol. 19, no.1, 2006) pp. 21-34. See also Muhammad Umer Chapra ‘Monetary Management in an Islamic Economy’ (Islamic Economic Studies, vol. 4, no.1, 1996) p. 5.

currency-gold ratio is the only proper solution. However, it seems the most appropriate solution is to link currency to the value of a basket of valuable assets (especially metals), and this could be a viable solution to get rid of the current problem of inflation.

It seems that there is a need to distinguish between the use of currency as a medium of exchange or payment<sup>38</sup> and the use of it as a pricing index. For practical considerations, it seems viable to adopt the former practice but there is no justifiable reason for the implementation of the latter one. As a solution, it seems the modern pricing index has to be changed and be linked to the average value of a pool/basket of products selected from a wider number of categories<sup>39</sup> of the economic sector in such a way that the average value of the combination of their prices indicates as much as

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<sup>38</sup> According to Good, *usually*, payment means the “transfer of money or of a money fund, or performance of some other act” offered and accepted in satisfaction of a “money obligation”, but usually the contracting parties employ the term to signify “some intermediate step”, such as a “conditional payment” (e.g., payment by cheque) or a “dispatch of funds”. The definition of payment in *law*, as per Good, is “a gift or loan of money or any act offered and accepted in performance of a money obligation. So, an act cannot constitute payment unless money is involved”. See Charles Proctor ‘Good on Payment Obligations in Commercial and Financial Transactions’ (Sweet & Maxwell, 2<sup>nd</sup> edition, 2009) pp. 8-9. However, some scholars do not believe that for an act to be considered as payment, the involvement of money is necessary. According to these commentators, for example as per Brindle and Cox, payment involves more than money in English law and the parties to a contract may treat any other act as payment “whilst payment often involves the performance of a money obligation, it does not necessarily involve the delivery of money. Money may not be delivered where another sum is set off, or an account settled. Money may not be involved where for instance goods are delivered in part exchange for new goods”. See Michael Brindle and Raymond Cox ‘Law of Bank Payments’ (Sweet & Maxwell, 4<sup>th</sup> edition, 2010) p. 1. It seems that the first definition is more precise than the latter one. What is argued by Brindle and Cox goes much beyond the definition of *payment* and it is actually the definition of *settlement*. So, the first view is more suitable as definition of payment.

<sup>39</sup> An important factor that has to be taken into account in the selection of this basket is that it should cover different products with intrinsic values from different categories e.g., agriculture, minerals, metals, manufacturing, and real property. Second, for the purpose of maximum stability in market prices, the price movement of these products should normally be in an opposite direction, in such a way that they neutralise (net out) each other to a very large degree. On this basis, the practice of ‘face value’ (which is set by the power of the states in paper currencies) is eliminated from the financial system and the governments desperate to supply more liquidity to cover their current expenditures or pay their debts will not be able to solve the problem by printing more money (as they do nowadays times of financial crises) and consequently create catastrophic effects on the economy in the long run.

possible, the true functioning of the economy and market price movement as a whole.<sup>40</sup>

### 8.3.3 Liquidity Management

In modern financial systems, internal money market tools are used for the management of short-term liquidity needs. Financial institutions, especially banks that need short term liquidity, borrow from each other at a floating interbank rate. They may also, under some circumstances, borrow from the central bank. All the financial tools that are used for this purpose are, in essence, loans i.e., lending transactions. As far as the practice of the internal money market in contemporary Islamic banking and finance is concerned, in 1993 Bank Negara Malaysia established the first ever Islamic Interbank Money Market using commodity *murabahas* or (organised) *tawarruq* tools for the purpose of liquidity absorption as well as liquidity injection into the Islamic banking sector.<sup>41</sup> Some *Sharia* authorities, namely, AAOIFI and the Mecca *Fiqh*

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<sup>40</sup> This suggestion is merely based on a rational reasoning and to be firmly proved it needs further research by the economists. A detailed discussion in this regard is beyond the confines of this thesis.

<sup>41</sup> In order to inject liquidity into an Islamic bank that is experiencing a liquidity shortage, Bank Negara buys a commodity from the commodities market on a cash basis at spot price and then sells the purchased commodity to the Islamic bank on a deferred payment basis (with a mark-up). The Islamic bank, then sells the purchased commodity in the commodities market on spot (often at the original purchase price paid by the Bank Negara) and pays the purchase instalments to Bank Negara at the specified times. Absorption of the excess liquidity of the Islamic bank by Bank Negara operates more or less in the same manner but in the reverse direction. In this mechanism, Bank Negara may appoint the Islamic bank as its agent to buy and sell the commodity. See Bank Negara Malaysia 'Annual Report 2007' (Kuala Lumpur, Bank Negara Malaysia, 2008) p.87. For somewhat different mechanisms see Asyraf Wajdi Dato Dusuki 'Islamic Finance: An Old Skeleton in a Modern Dress' (Kuala Lumpur: ISRA/INCEIF, 2008) p.229. A similar mechanism was adopted by Bahrain in 2002 with the establishment of a Liquidity Management Centre. This was also followed in Pakistan but with the introduction of new Sharia-compliant tools i.e., interbank *musharaka* (where the banks are invited to pool their contributions/assets in a *musharaka* scheme and share the generated profits on a pre-agreed ratio among themselves) and interbank *wakala* (where the investors, in order to invest and receive returns, provide their investable funds to Islamic banks in return for payment of a service fee to Islamic banks).

Academy have declared these liquidity tools illegitimate.<sup>42</sup> However, there are some *Sharia* scholars who argue for the *Sharia*-compliance of the (organised) *tawarruqs*.<sup>43</sup> Also, there are some other scholars who advocate the legitimacy of (organised) *tawarruqs* on the basis of social *maslaha* (public interest) invoking the wide practice and use of these tools in the Islamic finance industry.<sup>44</sup> Undoubtedly, because of the limitation of fixed return yielding instruments in Islamic finance, the Islamic financial institutions would likely face more liquidity concerns compared to their Western counterparts. It is also obvious that the more diversified the Islamic liquidity management tools are, the greater the degree of flexibility that the HMC will have to control the liquidity supply and also the more leeway the Islamic financial institutions especially Islamic banks (i.e., Payment and Deposit Intermediaries) will have to match and adjust the liability and asset side of their balance sheet. However, as per the Task Force on Islamic Finance,<sup>45</sup> for the protection of financial stability it is necessary to set up a vigorous national and international liquidity management scheme, on the basis of which central banks will have to act as the lender of last resort and supply liquidity to the market.<sup>46</sup>

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<sup>42</sup> As a result of the approach taken by AAOIFI and the Mecca Fiqh Academy, Bank Negara Malaysia has started developing new Islamic interbank money market tools with a particular focus on equity ownership instruments (i.e., an increasing attention on *mudaraba/musharaka* contracts both in the number and volume). See Jennifer Jacobs 'Laughing All the Way to the Bank' (Islamic Finance Asia, 27 August 2009).

<sup>43</sup> Akram Laldin, who is a member of Bank Negara's Sharia Board is one of the scholars who advocate this. See Nikan Froozye 'Tawarruq: Shari'ah Risk or Banking Conundrum?' Available via the Internet at [www.opalesque.com/OIFI12/Featured\\_Structure\\_Tawarruq\\_Shariah\\_Risk\\_or\\_...](http://www.opalesque.com/OIFI12/Featured_Structure_Tawarruq_Shariah_Risk_or_...)

<sup>44</sup> In this regard see Mohammed Khnifer 'Maslaha and the Permissibility of Organized Tawarruq' Available via the Internet at <https://mail.inceif.org/exchange>

<sup>45</sup> The Task Force on Islamic Finance of the Islamic Financial Services Board made some proposals called "(Eight) Building Blocks", in their meeting on April 2010, for the purpose of securing financial stability. These building blocks are largely borrowed from Western financial standards especially Basel II.

<sup>46</sup> For this purpose, the IFSB has set up a High Level Taskforce on Liquidity Management. See Task Force on Islamic Finance (IFSB) 'Islamic Finance and Global Financial Stability' (2010) p. 43.

### **8.3.4 Individual and Collective Independence**

Individual and collective independence adds to national wealth and a feeling of well-being in the society as a whole. The modern practice in many developed countries seems to be at odds with this goal, where fiscal laws urge people to borrow more and discourage investment and capital acquisition activities through taxing the profits earned from these activities and allowing tax exemptions on the interest paid on loans. These laws facilitate attractive pricing of the products like; mortgages (housing financing) and student loans (education financing) by financial institutions. The external effects of such designed products especially mortgages have been devastating on borrowers and the nation as a whole. For example, a house-owner who acquires the house based on a mortgage arrangement remains a debtor for virtually the rest of his working life and ends up paying several times the original market price of the house. If for any reason he fails to pay the installments on time, he will lose his ownership rights on the house and at best will be treated as a tenant. A student who is forced to get a loan for his education leaves college or university with a heavy burden and obligation. It is well understood that bonded people (and a bonded society, as well) lose their independence in virtually all their decisions and acts, and remain under the dominance of their creditors throughout their lives.<sup>47</sup> Economic independence is indeed a main precondition for independence in many other areas, e.g., social and political relationships. That is why a major economic policy, and one that the HMC should follow, has to be the empowerment of people to obtain their economic independence. A very suitable solution to pursue and achieve this goal is to foster microfinance and entrepreneurial practices in society.

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<sup>47</sup> See A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A. S. Noordeen, 2005) p. 9.

### 8.3.5 Transparency and Simplification of the Business and Financial Transactions

Transparency and the simplification of business and financial dealings is another rule that the HMC should heed. In order to make transactions more transparent, some major changes need to be adopted in information disclosure standards and modern accounting and auditing standards (e.g., realised accounts practice should be implemented instead of the current practice of expected accounts). It may be argued that the need for transparency, which is required for a sound and informed business and financial decision, is the necessary implication of *hifz al-aql* (protection of the mind and intelligence<sup>48</sup>) in *Sharia*. Transparency in the economic and financial system is very important especially when it comes to Islamic finance, to see if any element of *Sharia* non-compliant, such as interest is used in the financial system. In other words, an important necessary reform in the structure of transactions in the financial system is to make them as simple as possible, in such a way that they are easily understandable by the system participants. This would reduce the transaction cost as well as the intermediary chain and would also create more confidence in the financial system. This goal may be achieved through the standardisation of contracts in the financial system.

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<sup>48</sup> Hifz al-aql is thought to be one of the essentials of Maqasid al-Sharia (the objectives of Sharia). It may be said that the elimination of the information asymmetry and so, the necessity of knowledge-sharing, is dictated by this essential concept according to Sharia. See Murat Cizakca 'Islamic Capitalism and Finance: Origins, Evolution, and the Future' (Edward Elgar: Studies in Islamic Finance, Accounting, and Governance, 2011) p. 241.

### **8.3.6 Disallowing Socially Detrimental Activities and the Activities Detrimental to the Entire Economy**

Disallowing activities that were socially and economically detrimental would be another way of improving society. Any economic, business, investment, and financial activity should be disallowed if it gives no individual or social benefit or if its harmful effects<sup>49</sup> outweigh its benefits. Nobody will be allowed to exercise his right if it is detrimental to others especially if it is contrary to social interests and public order.<sup>50</sup> In case of any conflict, the application of the latter would prevail over the former. One of the most devastating practices in the modern financial industry is risk-trading because it can destabilise the economy as a result of a higher systemic risk created by risk-trading activities. Today, many tools and financial innovations are used in this regard.

### **8.3.7 Cutting Short the Intermediary Chain in the Economic and Financial Activities**

For the proper allocation and reduction of the cost of access to products and also financial facilities, it is essential to eliminate the unnecessary activities of intermediaries in the chain of distribution and the allocation of products and funds. Islam discourages intermediary activities and, as far as possible, intermediary activity should be eliminated from the cycle of distribution. It is obvious that, the more intermediary activities there are, the greater the prices of products and services will

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<sup>49</sup> Ibn Taymiyya has considered the “respect for the rights of one’s neighbour” as one of the very purposes of Sharia (Maqasid al-Sharia). See Jasser Auda ‘Maqasid al-Shari’ah as Philosophy of Islamic Law’ (Washington D.C.: International Institute of Islamic Thought, 2008) pp. 5- 8.

<sup>50</sup> See the Constitution of Iran article 40. Also, Murtaza Mutahhari ‘Barrasiye Ijmaaliye Mabaniye Iqtisade Islami’ (Tehran: Hikmat, 1403 Lunar Hijri Calendar) pp. 175-177. It may be said that people in society have a kind of joint and several responsibility towards each other. The destiny of people in society is dependent on one another. Also, see Muhammad Taqi Ja’afari ‘Manaabe Fiqh (a.k.a. Rasaaeel Fiqhi)’ (Tehran: Mu’assasa Nashr Karamat, 1<sup>st</sup> edition, 1377 Solar Hijri Calendar) pp. 132-134.



be. Also, more intermediary activities mean less incentive for productive activities and will also cause more problems in the correct distribution of wealth in the economy.<sup>51</sup>

### **8.3.8 Reliability and Credit Rating Standard**

In order to create equal access to financial facilities, especially small and medium-sized facilities, and also in considering an efficient cost of access to the facilities, it is necessary to replace the burdens of surety and guarantee with the credibility ratio of the facility receivers. Additionally, to ensure the proper functioning of the business and financial institutions especially their degree of compliance with the policies and rules of the HMC, they (including the products and services that they provide) will have to be rated by rating agencies, operating under the HMC. If the institutions and/or the relevant products and services that they provide do not meet a certain threshold of compliance,<sup>52</sup> the license of the institutions and/or the supply of the relevant products or services have to be removed or disallowed respectively. The

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<sup>51</sup> See Murtaza Mutahhari 'Mas'alaye Riba wa Bank (bi Dhamimeye Mas'alaye Bime)' (Tehran: Sadra Publications, 14<sup>th</sup> edition, 2005) p. 98.

<sup>52</sup> Concerns over Sharia-compliance can be one of the determining factors regarding the threshold of compliance. Currently, most Islamic financial institutions have created Religious or Sharia Supervisory Boards to annually review the operations of the financial institution and to see whether and to what extent the operations of the institution, especially its products and services, are according to Islamic law. They examine on a test basis each kind of transaction entered into by the financial institution and any evidence to show that the transaction and dealings entered into by the financial institution were in compliance with Sharia rules and principles, submitting an annual report to the shareholders in that respect. This is the case, in particular in the countries where there is no legal prescription as to what does and what does not constitute "Islamic" banking or finance. For more on this matter see Mohd. Daud Bakar and Sayd Farook 'A Universal Platform for Shari'a Compliant Equity Screening' (Oxford Islamic Finance and Dar Al Istithmar, White Paper 7/7/2009). Other criteria for rating financial institutions can be: the simplicity of their financial products, the lower cost of their financial services, the diversity of their customers, their involvement in microfinance and charity-based activities. The IFSB and the AAOIFI provide rating services for the Islamic finance industry. How far their services have contributed to the improvement of the Islamic finance industry remains under serious doubt. See Task Force on Islamic Finance and Global Financial Stability 'Islamic Finance and Global Financial Stability' (Kuala Lumpur/Jeddah: IFSB/IDB/IRTI, 2010) p. 33.

analysis of the rating outcome will provide management information that is very useful for effective control and also critical to the financial institution's internal management as well as the purposes of the regulatory and supervisory authority.<sup>53</sup>

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<sup>53</sup> For a similar approach see A. L. M. Abdul Gafoor 'Islamic Banking & Finance: Another Approach' (Kuala Lumpur: A. S. Noordeen, 2000) p. 15

## **Chapter Nine:**

## **Conclusion**

## **9.1 A New Solution to Unfair Distribution of Wealth and Systemic Financial Instability**

Having recognised that the modern economic and financial systems have failed to secure a lasting solution to a just and fair system of distribution of wealth and have frequently been exposed as containing systemic failures, this research project suggests a new paradigm called “Balancism” (a balance of rights and duties) to address these very critical problems. Rights are either granted (in principle, on the basis of *needs*) or acquired (in principle, on the basis of *contribution*). In other words, rights are granted over primary wealth and acquired over subordinate wealth. Duties, in turn, follow rights. Justice is met when the rights or benefits (one side of the scales) and duties or burdens (the other side of the scales) are balanced.

## **9.2 The First Tier of the Model**

It is thought that the starting point in designing any proper model is to designate the ultimate aim of the system and, accordingly, the foundational theory and the fundamental principles and policies. On the basis of this understanding, the thesis considers “social justice/social balance” as the ultimate objective of the new paradigm and “balance in rights-and-duties<sup>1</sup> in the general sense, and benefits-and-burdens in the economic sense”, as the foundational theory. As a consequence of the implications of the ultimate aim and foundational theory of the alternative model, the underlying principles and policies on the basis of which the rest of the model i.e., the second and

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<sup>1</sup> The “Rights-and-Duties Balance” theory is applicable and adaptable to a variety of different subjects, e.g., politics. Its proper variant in the field of politics is “Powers and Accountabilities Balance” theory.

the third tiers of the model formed are clearly defined. The followings are the most important principles and policies of the new model:

**One.** Every human being is entitled to enjoy and benefit from the natural wealth resources entrusted to them by the absolute owner (the Creator) yet nobody can in principle claim to be the beneficiary of a specific part of the natural wealth until it is distributed on the basis of reasonable and legitimate needs of every person.

**Two.** The proceeds of natural wealth resources is essentially distributed to secure basic essential needs of every person such as a dwelling house, education and health care facilities and the provision of basic infrastructure utilities.

**Three.** People can never acquire the ownership of the natural wealth resources (“the origins of wealth”) and it remains always under the control of the people as a whole.

**Four.** People are unable to transfer the ownership and control of the natural wealth resources to anybody else including the state.

**Five.** The equitable distribution prevails over efficiency rule. As a result, in case there is any conflict between distribution and efficiency rules, the distribution policy will override the efficiency theory. This is simply because the social balance and social welfare are given priority over the concentration and maximization of material wealth.

**Six.** Everybody has to be provided with equal access to economic and business opportunities.<sup>2</sup>

**Seven.** The benefits and burdens arising out of the profit-making activities have to be shared pro rata among all participants according to their contribution; whether it is a tangible (e.g., capital) contribution or an intangible (e.g., labour) one. In consequent, currently practiced labour employment structure (i.e., employer-employee relationship) and the fixed compensation practices are abolished in the

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<sup>2</sup> For a similar regulatory support see the Constitution of Iran article 43 (section 2).

business and investment context. Instead, partnership structures and profit and loss sharing rules will be in operation. In other words, everybody that contributes some form of tangible or intangible values to a given for-profit business form or collective financial scheme has to be treated as a shareholder or partner of the given scheme with the right of joint ownership and control.<sup>3</sup> On this basis, the wealth that is concentrated in the given business or financial scheme is not controlled by a few but by all contributing participants to the scheme. This is a kind of synergy of belongings that benefits the economies of scale and improves effectiveness. Therefore, the practice of modern partnerships, joint stock companies, venture capitals and mutual funds (in which all the partners and shareholders benefit from a joint right of ownership and control) are largely acceptable practices though the operation of the limited liability shield and also the implementation of the employment structure and fixed compensation schemes are still major concerns in these modern business forms. However, those of modern banks are not acceptable, as depositors have no right of ownership and control over the use of their deposits.

***Eight.*** The return to contributors in a profit-making context should not be firmly fixed (as it is practised nowadays in interest-based loans), because it is not only an irresponsible form of making a profit (as a result of disregarding socio-economic realities) but also creates inequality and an imbalanced distribution of wealth which eventually leads to injustice. Following this policy, the zero-sum techniques such as betting and gambling in which a gain by one participant is an exact equal loss of the other participant, have to be totally discarded. Also, the techniques in which the gain and loss of the participants of the scheme are significantly disproportionate or

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<sup>3</sup> Unlike the current practices, in the new suggested model, the right of control is not separated from the right of ownership. In other words, Ownership and control unity is applied. They are owners that control the business form or collective financial scheme. On this basis, the traditional agency problem and the problem of conflict of interests are no longer considered problems in the new model.

imbalanced<sup>4</sup> especially those transactions in which the purpose is to take advantage of the risk of others have to be entirely prevented. The current lending<sup>5</sup> techniques, which are disconnected from real economic commitments, have to be replaced by new alternative financing methods designed mainly on the basis of profit and loss sharing and commitments in real economic terms.<sup>6</sup> For this purpose, new investment products have to be introduced and the accounting standards and tax rules changed accordingly.

**Nine.** Business forms and products, and financial facilities have to be clearly defined and also simply structured in a way that they are easily usable by and understandable<sup>7</sup> to any participant in the business environment and financial system. Simplification of business and financial products may reduce transaction costs and

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<sup>4</sup> In Islamic law, this is supported by the concept of “ghabn” (intolerable excessive loss). In case a ghabn is found in a transaction, it gives the losing party an option to terminate the contract.

<sup>5</sup> By definition, banks are not allowed to engage in real economic activities but just act as lenders to economic actors irrespective of the fact that their advanced loan to a given borrower results in loss or is consumed by the borrower with no profit-earnings. It is this disconnection from the real economic investments that makes banks unfit for lending. Therefore, lending activities have to be left to other institutions that are able and have no barriers to engage in real economic activities. However, in case, by a new definition, the inherent function of the banking institutions is radically changed from being just financial intermediaries to getting involved with real economic activities, and they act on a contingent profit and loss sharing basis, then the banking industry is no longer considered a financial intermediary industry but categorised and governed under the rules of for-profit business schemes.

<sup>6</sup> Unlike the current lending techniques in which the main concern is the predetermination of interest rates (requiring strict and static decisions and supervisions), profit and loss sharing arrangements require flexible and dynamic solutions.

<sup>7</sup> It is obvious that the function of law is to provide legal certainty and security. This feature is missing in Islamic law simply because there is a diverse interpretation on various Sharia issues across Islamic jurisdictions, which stems from the different schools of thought among Sharia scholars. Different jurisdictions have employed different practices and there is a lack of a uniform approach in addressing regulatory issues pertaining to Islamic products and services. Therefore, it would be too risky to designate Sharia or Islamic law as the governing substantive law in business and financial transactions. To serve as an applicable law, it has to be in the first place harmonised, standardised and eventually codified in the form of statutes and regulations. For a somewhat similar finding see International Organisation of Securities Commission (IOSCO) ‘Islamic Capital Market Task Force Report’ (2004) pp. 63-65.

enhance transparency. Complexity, on the other hand, can be a cause of imbalance and instability.

**Ten.** The limited liability shield currently in place should be replaced by an unlimited proportionate liability rule in a business and investment environment.<sup>8</sup>

**Eleven.** The application of legal personality concept is adopted due to practical concerns but only for very limited purposes.

**Twelve.** Concerning the provision of not-for-profit facilities, the supply of these products made by anybody is essentially to help others free of charge and for some good purposes.

**Thirteen.** As regards microbusiness activities, microfinance tools and products are designed to empower poor to obtain their economic independence. The instruments designed for microbusiness purposes are basically cooperative-oriented schemes seeking to foster a spirit of cooperation.

**Fourteen.** Socially-responsible and cooperative schemes have to be initiated and developed on a very large scale in the entire economy.

**Fifteen.** With regard to intermediary tools and services, in cases where an intermediary is used for not-for-profit purposes the intermediary has to be rewarded on fixed-compensation basis and in the case of using the services of an intermediary

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<sup>8</sup> A comparative research of business associations conducted by Foster shows how the Islamic world has adopted and implemented the Western-style limited liability rule and its very closely connected concept i.e., legal personality with no practical resistance and enough critical attitude towards its compatibility with Sharia. See Nicholas H. D. Foster 'Islamic Perspectives on the Law of Business Organisations II: The Sharia and the Western-style Law of Business Organisations' (*European Business Organization Law Review*, vol. 11, issue 2, 2010) pp. 283-288. In its Resolution (63/1/7, para. 12, 1992) the Council of the Islamic Fiqh Academy has approved the compatibility of (company) limited liability with Sharia, simply reasoning that since the operation of the limited liability rule is known to the clients of a company there could be no deception in this regard. The Resolution is available at: <http://www.fiqhacademy.org.sa>. However, as it was discussed before (especially in the foundational theory and also musharakas sections of the thesis), the reason for the incompatibility of limited liability is not deception but other strong intellectual reasons and religious authorities.



for profit-making purposes the intermediary has to be rewarded on sharing-in-benefits basis.

**Sixteen.** The philosophy of financial intermediaries operating in the financial system should be the circulation of wealth across the economy rather than its concentration.<sup>9</sup> In consequent, unlike the current commercial banking practices, Payment and Deposit Intermediaries (PDIs) will receive only service fee in return for the provision of intermediary services where the ownership and control of the payments and deposits remain with the customers and depositors themselves. The most proper legal tool for deposit-taking facilities is a *wadi'a* contract.

**Seventeen.** The concentration of wealth in the economy should be seriously prevented<sup>10</sup> because it is an unjust transfer<sup>11</sup> of wealth (or at least has a detrimental element), that the deposit-taking institutions are allowed to take the deposits that belong to others under their sole control and ownership and then become powerful enough to dictate their self-interest wishes across the economy as well as expose the

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<sup>9</sup> Unlike current practices, banks should act merely as capital-circulators but not capital-lenders. In modern banking practice, unlike their historically earlier practices, banks do not use their own funds to lend borrowers but in fact the funds that they have in their custody on depositors' behalf. Depositors receive a deposit interest (because they are treated as lenders to banks) and the banks, in turn, receive loan interest (because they, but not depositors, are considered as lenders to borrowers). That is why, the legal relationship between depositors and banks has to be radically overhauled according to the policy that 'banks should act merely as capital-circulators but not capital-lenders'. In this thesis, it is concluded that there is no legitimate and compelling reason to believe that banks can take the ownership of the deposits and lend them out (which in fact belong to others) as their own.

<sup>10</sup> For regulatory support see the Constitution of Iran article 43 (section 2) and Act on Cooperative Sector of Economy of Islamic Republic of Iran 1991 article 1 (section 3). For a religious support of this idea see the Quran (59:7) "so that it (wealth) should not merely circulate between the rich among you" (...kay laa yakuna dowlatan bayn al-aghniya' minkum...).

<sup>11</sup> In practice, banks take deposits from everybody that they can (from individuals to corporations and from the poor to the rich) but when it comes to lending they do not lend them out to everybody, only to corporations or the rich. This is an additional example of how an unjust transfer of wealth happens in the modern banking system. This unjust transfer gets even worse when the central banks set the interest rate too low whereby the rich borrowers take a chance to utilise the wealth that belong to depositors at very low cost of borrowing while the depositors receive too little interest on their deposits.

financial system to catastrophic systemic risk when they go bankrupt. Furthermore, concentration of wealth can lead subsequently to concentration of power and eventually cause massive corruption in the whole system. Also, as per *Sharia*, savings accounts are strongly discouraged by the extra imposition of *zakat* (tax) on savings.

***Eighteen.*** With regard to access to financial facilities, everybody (especially concerning a not-for-profit context) has to be rated and provided with facilities according to one's credit background<sup>12</sup> rather than one's ability to provide human or capital collateral. If it comes to a choice between using one of these two types of collateral, priority should be given to the human collateral rather than capital collateral.

***Nineteen.*** The underlying rationale for risk insurance is to minimise risk rather than taking advantage of risk and trading in it. The risk insurance and hedging providers should not be allowed to get involved in profit-making investment and trade activities.

***Twenty.*** Currency and legal tender should be used merely as an official medium of payment and redemption of a debt not as a pricing index. Value measurement should be linked to a combination of assets (called a "basket of valuables"), representing the average movement of the value of assets in the economy.<sup>13</sup>

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<sup>12</sup> However, it should be noted that, in credit rating process, any payment default occurred due to the inability of the customer to pay has to be disregarded. In other words, only those defaults happened despite the ability of the customer to pay will be taken into account in his credit background rating.

<sup>13</sup> This initiative may resolve some major concerns in Islamic banking and finance: *riba* and inflation. It may be argued whether the old Islamic rules governing gold-based and silver-based coins are still applicable to paper currency. This concern, however, will simply be removed if the paper currency is considered a mere medium of payment but not a pricing (value measurement) index. This approach can also, though arguably, solve the problems of currency depreciation value and consequently inflation in the economy.

### 9.3 The Second Tier of the Model

The followings are the building blocks of the second tier of the model:

**One.** Primary (natural) wealth has to be distributed on the basis of reasonable and legitimate needs of every person subject to equity<sup>14</sup> (*insaaf*) principle, i.e., according to the type and amount of needs of every person in society when all circumstantial evidence has been taken into account.<sup>15</sup> On the other hand, subordinate wealth has to be distributed according to the amount of contributions (*sa'y*) everybody has made in a given economic or business activity.<sup>16</sup> The distribution of primary wealth, unlike the distribution of subordinate wealth that has to be governed in principle by private law, is ruled in principle by public law.

**Two.** The granted or acquired right/wealth may be consumed, accumulated or disposed of. With regard to the consumption of wealth, it has to be for reasonable and legitimate needs while avoiding *israf* (consuming beyond reasonable needs, extravagance) and *itlaf/tabdhir* (consuming wastefully, dissipation). In respect of the accumulation of wealth, the wealth may be stored up for reasonable needs but it should not be hoarded (*ihthikar*). Regarding the disposal of wealth, it may be circulated in the economy using the legitimate transactional tools and it can be disposed of either for-profit, profit-free, or for benevolent purposes.

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<sup>14</sup> As per equity, all surrounding circumstances with regard to a given matter have to be taken into consideration. It is the concept of equity that gives way to the exercise of *maslaha* (discretion) in some necessary circumstances.

<sup>15</sup> It is clear that the type and amount of needs of human beings are not exactly the same and equal. That is why the distribution of primary wealth has to be made equitably rather than equally. However, in this regard, eventually there has to be a balance between the rights and duties of everybody.

<sup>16</sup> The major cause of the ever-increasing gap between the rich and poor is inequitable and unjust distribution of primary and subordinate wealth among the people. Compliance with the mentioned distribution rules may significantly contribute to poverty alleviation and reduce the gap between the rich and poor.

**Three.** Usually, a holder of right/wealth would use his wealth for profit-making (investment or trade) purposes though he may use it for not-for-profit causes.<sup>17</sup> The techniques used to make a profit have to be responsible forms of investment. For this purpose, profit and loss sharing arrangements will have to be implemented rather than lending and borrowing techniques. By applying profit and loss sharing schemes (*musharakas*), the obligations of the investors and entrepreneurs will be contingent and subject to the outcome of the investment activities, unlike the lending transactions where the investors are certainly obliged to repay the loans irrespective of the outcome of the relevant investment projects. That is why the use of *musharakas* can effectively prevent businesses and entrepreneurs going bankrupt due their inability to pay back their loans, which may cause devastating systemic instabilities in the whole economic and financial system. In *musharakas*, the return for each participant-investor is computed on the basis of profit and loss statements of the investment scheme at the end of the accounting period. In contrast to the modern practices of anticipated and pre-fixed scandal-prone accounts, the profit and loss accounts are realised accounts and hence, neither speculation nor uncertainty is involved in these accounts.<sup>18</sup> Every participant-investor that contributes to the

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<sup>17</sup> “whoever enjoys profit has to shoulder all associated costs and losses”, “nobody can own something unless that thing is acquired as a result of one’s (effort) contribution”, and “unlimited proportionate liability” standards are the rules that are mainly applicable in a profit-making context but not in the context of not-for-profit and philanthropic purposes. The rules applicable to the latter category are governed under the Sharia concepts, mainly, “try to excel one another in good works” according to the Quran (2:148); “try to spend out of what the Creator has provided you with or what you have acquired” according to the Quran (14:31- 2:3 & 4 & 5 & 254 & 261 & 262 & 263 & 264 & 265 & 267 & 268- 42:38- 3:134- 4:38- 8: 36 & 60- 34:39- 57:7 & 10- 63:7 & 10- 64:16); “surely Allah enjoins justice, kindness and the doing of good” according to the Quran (16:90); “can the reward of goodness be any other than goodness?” according to the Quran (55:60). Therefore, to determine the applicable rules, the financial products and facilities that are used for not-for-profit and benevolent causes have to be distinguished from those that are used for profit-making purposes. The products and their governing rules must match their purpose.

<sup>18</sup> A similar approach has been concluded by some Islamic scholars. See A. L. M. Abdul Gafoor ‘Islamic Banking & Finance: Another Approach’ (Kuala Lumpur: A.S. Noordeen, 2000) pp. 9-10.

investment project whether his contribution is in an intangible form (e.g., labour, expertise, or professional management) or in a tangible form (e.g., capital or equipment) he shares in profits and also losses (if any) in proportion to his contributions made to the investment scheme. As a result, unlike the modern practices, as per the new alternative model, there will be no employment setting in operation in the profit-making context.<sup>19</sup> All participants-investors in a given investment activity will establish a partnership setting among themselves. For example, a third party financier who provides capital to the investment scheme is no longer considered to be a lender but rather one of the partners of the investment scheme whose supply of capital is considered as his contribution to the investment scheme.<sup>20</sup> Similarly, a worker who works for the investment project is no longer considered an employee but rather one of the partners of the investment arrangement whose supply of labour is deemed as his contribution to the investment activity.<sup>21</sup> There are Western investment schemes that can be considered best practice, which are capable of being implemented within the new alternative model with some minimal amendments. These are: partnerships, joint stock companies, venture capital firms, mutual funds (open-end and closed-end), and private equity (funds). In respect of trading and business activities, an owner of an asset may trade his assets using *murabaha* (cost plus mark-up sale), *bay nasiya* (spot delivery in return for deferred payment sale), *ijara wa iqtina* (leasing with an option of purchase), *salam* (spot

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<sup>19</sup> As per the Constitution of Iran article 43 (section 4), the exploitation of another's labour has to be prevented. For another regulatory support see "Act on Cooperative Sector of Economy of Islamic Republic of Iran 1991" article 1 (section 5).

<sup>20</sup> This approach, in which the return to the financier is contingent and it is linked to the revenues generated from the investment project, may resolve one of the major challenging issues in contemporary Islamic banking and finance, namely, the problem of *riba*.

<sup>21</sup> This attitude, in which the positive or negative return to every single participant of the scheme is adjusted according to his contributions made to the scheme, may resolve some major ever-challenging issues in the modern economies namely the problem of workers' compensation, high unemployment rates, and the gap between the rich and poor.

payment in return for deferred delivery sale), *istisna* (selling a would-be constructed product), and *bay shart* (sale with an option of repurchase).

**Four.** A holder of wealth may dispose of his wealth not only on for-profit activities but also for not-for-profit and microbusiness purposes. Major legal techniques that are suitable for surrendering benefits while keeping the corpus of the property itself are: *qard hasana*<sup>22</sup> (interest-free loan), *a'riya* (use-free contract), and *haq intifa* (enjoyment privilege). Moreover, the holder of wealth may sometimes intend to or in some circumstances is obliged to surrender some part of his wealth for some specific purposes. The former surrender, which is essentially for philanthropic causes can be achieved by way of using one of these facilities: *waqf* (voluntary endowment), *hiba* (voluntary gift), or *sadaqa* (voluntary almsgiving). The best modern practices in this regard, which are capable of being implemented within the new model with only some minimal adjustments are (charitable) trusts and pension funds. Those types of surrenders that have to be made to the (Treasury of) the House of Wealth and also in some cases to the Treasury of State<sup>23</sup> are; *kharaj* (a certain portion of the proceeds of natural wealth/resources in return for the use of the licensees) and *zakat* (tax-like obligatory payment) duties. The revenues of (the Treasury of) the House of Wealth are mainly used to ensure the living essentials of the needy in society and also

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<sup>22</sup> A loan (*qard hasana*) may be used by its borrower for his profit-making purposes; though, it has been basically recognised for financing the essential needs rather than for-profit purposes. That is why one of the most proper facilities that can be used for microbusiness (profit-making) purposes is *qard hasana*. For a somewhat different view in this regard see A. L. M. Abdul Gafoor 'Interest, Usury, Riba and the Operational Costs of a Bank' (A.S. Noordeen, 2005) p. 38.

To avoid *riba* as well as the problem of value erosion of the money currency (as a result of inflation), the asset (i.e., the purpose) for the provision of which the loan (*qard*) is provided can be used as a pricing index. Therefore, there would be no single pricing criterion, e.g., gold standard index but rather different pricing indexes in accordance with the different needs and purposes for the provision of which the loans are provided. This multiplicity approach in defining different price indexes would help in turn to avoid the negative consequences of speculative hyper-inflation of one single asset like gold if only that single asset (like gold) were to be designated as a pricing index.

<sup>23</sup> As per the research model, the state should not get involve in economic and business activities but rather it should protect and help the enforcement of economic and business rules.

basic public goods. The income of the Treasury of State is basically used to run the political government including the salaries of civil servants, the protection of borders and national defence. With respect to the microbusiness purposes, the most suitable and powerful tools for alleviation of poverty and achieving economic independence are cooperative-oriented (*ta'awun*) arrangements.

**Five.** It is not possible for everybody to conduct all their economic, business, or financial activities personally and sometimes they have no choice but to use some appropriate intermediary services or facilities to carry out specific purposes e.g., transfer of funds, safe-keeping, agency, and marketplace services. Using intermediary services is not, in and of itself, to make profit from the endeavours of the service provider,<sup>24</sup> otherwise, the rules governing profit-making schemes will be applied to the relationship of the parties (the rules of *mudaraba* arrangement, mainly). In general, the intermediary services may be needed either for legal and administrative tasks, or physical works. The proper legal tools for the former purpose are: *hiwala* (assignment of a debt or credit contract) and *aqd daman* (debt guarantee contract) regarding the facilitation of payments or transfer of funds and also the provision of assurances in order for the discharge of debt obligations; *wadi'a* or *amana* facility for the purposes of safe-keeping-deposits; and *wakala* contract for agency purposes. The proper legal tools for the latter purpose are *ijara al-shakhs* (labour employment) and *ji'ala* (reward contract) tools.<sup>25</sup> The most suitable modern facilities concerning intermediary services,

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<sup>24</sup> In case it is adopted that the intermediaries, unlike the current practices, cannot make profit from their intermediary services but rather they have to be merely compensated with certain remunerations in return for their provision of services, the detrimental role of intermediaries in conducting highly risky and speculative activities in the economy will be significantly reduced.

<sup>25</sup> *Ji'ala* may be used in both a profit-making context and a not-for-profit context. In the former context, the reward to an *a'mil* has to be a portion of the result of performance (e.g., a discovered product) or a percentage of its total market value in proportion to the contribution of an *a'mil*. In the latter context, the reward to an *a'mil* has to be a fixed known recompense (i.e., fixed compensation). *Ijara al-shakhs* can only be used for not-for-profit purposes, not for profit-making.

which are capable of being implemented within the new model with only some minimal changes, are: commercial papers, documentary letters of credit, debit and credit cards, and agency. Regarding the agency, a major change is needed in respect of the compensation made to the agent by the principal while distinguishing profit-making agents from agents employed for not-for-profit activities. To facilitate the trade and exchange among the sellers and buyers, appropriate marketplaces have to be set up where the necessary trades and exchanges will happen among different market participants on the basis of *bay* (sale), *mu'awada* (exchange of non-monetary assets), and *sarf* (exchange of monetary assets) including different variants of these basic legal tools such as *salam* (deferred delivery sale), *murabaha* (cost plus mark-up sale), and *bay nasiya* (deferred payment sale).

**Six.** Very reasonable and legitimate needs of people are to protect their lives and assets against risk of loss and damage. Therefore, hedging facilities are needed to address this concern. The philosophy and underlying rationale of hedging and insurance is to minimize rather than take advantage of risk, that is to say, risk-trading is not allowed.<sup>26</sup> Hedging can be made either through human collateral such as *aqd daman* (debt payment guarantee) and *kifala* (personal surety) or capital collatera such as *rahn* (collateral), *daman uhda* (guaranteeing legal risks pertaining to a given property) or *daman darak* (guaranteeing economic risks pertaining to a property). As a last resort, the hedging can be made on the basis of a *sulh* (compromise) facility: the

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<sup>26</sup> Taking advantage of or trading in risk is closely linked to the concept of forbidden *gharar* in Islamic laws. In modern terminology, it can be said that the philosophy and the economic rationale of the prohibition of taking advantage of risks (or tradings in risks) is to avoid systemic risks of bankruptcy and the creation of bubbles in economic values which in turn may cause social imbalance. As per al-Gamal "the transfer of credit and risk [is allowed] only if bundled within a financial transaction such as sales, leases, and partnerships. Such bundling regulates the riskiness of financial transactions, thus allowing for necessary risk taking to encourage investment and economic growth, while minimizing individual and systemic risks of bankruptcy and wild fluctuations in economic values". See Mahmoud A. El-Gamal 'Islamic Finance: Law, Economics, and Practice' (Cambridge University Press, 2006) pp. 164-165.



compensation of damages (if any) in return for payment of a premium. It is legitimate to make a compromise if the subject matter of the compromise (*sulh*) is a legitimate, reasonable, and beneficial act.

#### **9.4 The Third Tier of the Model**

From political economy perspective, the superstructure of the suggested model makes a dramatic change in the separation of powers governance which is currently a dominant model in modern political regimes and has been widely incorporated in the constitution code of these political governments. A new “Economic Authority” which is conceptually and institutionally a separate and independent authority from the political government is set up to take over the administration of distribution of natural wealth resources and the control of circulation of subordinate wealth. The Economic Authority consists of a House of Wealth and a House of Market Control. The distribution of primary wealth is conducted by the House of Wealth. A board of trustees (*mutawallis*) will be elected directly by the people or indirectly by the representatives of the people i.e., a Parliament to run the House of Wealth and distribute the primary wealth among the members of the public.<sup>27</sup> On the other hand, to ensure the proper functioning of the economic and financial system it is unavoidable to have to establish an authority to control the system. This authority, as an exclusive and unified policy maker of the system, is called the “House of Market

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<sup>27</sup> The political government has no ownership right in primary wealth i.e., natural resources. It is only human beings that hold the privilege of enjoyment of the natural wealth resources in compliance with equity distribution rules as explained above. The Creator of natural wealth resources has entrusted these resources to human beings as a whole for their legitimate and reasonable use and enjoyment. The ownership of the primary wealth remains with the Creator or the public as a whole, forever and the political government has no right of ownership and control over this natural wealth.

Control” (HMC).<sup>28</sup> The philosophy underlying the establishment of HMC is to control the proper production, distribution and circulation of subordinate wealth in the economy in order to ensure that the ultimate objective of the system, i.e., “social justice” prevails. The HMC is run by a board, appointed by representatives of the people, i.e., a Parliament<sup>29</sup> or elected directly by the people (similar to the House of Wealth) with broad policymaking and regulatory powers over the operation of the products, institutions and markets, including the power to issue rules with the force of rules and policies. The Parliament, in turn, controls the performance of the HMC and also the House of Wealth.

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<sup>28</sup> It is noteworthy that the HMC set up under the new model here is different from the Financial Services Authority (“FSA”) set up in the UK after the Financial Services and Markets Act 2000 (“FSMA”). The HMC will have to control not only all financial activities but also all other non-financial activities with the exception of distribution of natural wealth resources.

The FSA was a single integrated regulatory and institutional authority for administration of all financial services and financial markets in the UK. As per Walker, this sophisticated and complex regulatory and institutional regime (when it was in operation) made the UK financial system clearly distinguishable from many other similar foreign experiments including the US. The FSA was a private as opposed to public entity although its board was appointed and supervised by the Treasury and it was carrying out public functions (but independently of government). See George Alexander Walker ‘Financial Services Authority’ in Michael Blair QC, George Walker and Robert Purves ‘Financial Services Law’ (Oxford University Press, 2<sup>nd</sup> Edition, 2009) pp. 7-66. See also George Alexander Walker ‘United Kingdom Regulatory Reform: A New Beginning in Policy and Programme Construction’ in D Arner and JJ Lin ‘Financial Regulation- A Guide to Structural Reform’ (2003), chapter 7. It should be noted that the Financial Services Act 2012 received royal assent on 19 December 2012 abolished the FSA with effect on 1 April 2013 when the Act came into force. The functions of the FSA have now been split between the Bank of England, the Prudential Regulation Authority, and the Financial Conduct Authority. See Gonzalo Vina ‘U. K. Scraps FSA in Biggest Bank Regulation Overhaul Since 1997’ (Businessweek, Bloomberg) Retrieved 17 April, 2013.

<sup>29</sup> It seems proper if an independent Parliament (separate from the one that is practised today, on the basis of the theory of separation of powers, as one of the branches of the government) is set up to establish and control the House of Market Control and also the House of Wealth. The major rationale for this initiative is that if the control of these Houses rests in the hands of the political state, the state (in addition to its excessive entanglement with economic and business activities) will likely spend the natural wealth resources and public income more on the development of its political ambitions and hence ignore the priorities in spending the public wealth for the well-being and prosperity of members of the public, who are indeed the true beneficiaries of all such revenues and wealth resources. The state has to be dependent on and remains under the control of the public but not vice versa. Otherwise, if the state feels independent of its nation, it will not take care of the true needs of the people. The state, in and of itself and without its relevant nation, has no philosophy and reason to exist at all.

A true alternative economic, business, and financial model will never be discovered or created by the sudden actions of governments or communities, unless it is done on an individual and a collective level and in an interdisciplinary way, to include: philosophy, religion, law, sociology, economics, and politics. In other words, the true solution should benefit from major subjects of social science and it cannot be imposed or suddenly legislated, it can only grow up from the ideas of dedicated researchers over a long period. Undoubtedly, once this sound model like the one suggested by this research project has been created it will not flourish unless it is implemented in an appropriate political environment with the backing of trustworthy authorities who respect and enforce the rules of “rights-and-duties balance” in society.

## 9.5 Suggestions for Further Research

- Whether and to what extent is the application of Balancism efficient and can lead to economic developments?
- How can the House of Wealth be organised and managed? What is the relationship between the House of Wealth, the House of Market Control and the Government?
- What can be considered a contribution and how can the contributions of different participants in profit-making schemes be measured and awarded?
- Whether and to what extent risk-trading practices are reasonable and legitimate? And, whether and how far can they cause systemic risks?
- To what extent is the concentration of wealth and systemic instabilities interrelated?
- Is it possible to use money (currency) merely as a medium of payment but not as a pricing index? What would be a more suitable pricing index?
- Whether it is legally possible and economically viable to set up an international financial organisation in order to respond to the financing needs of countries on the basis of profit and loss sharing techniques?

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